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TAMING CORPORATE OVERHEAD: A KEY TO RESTORING HOSPITAL OPERATING PROFITS

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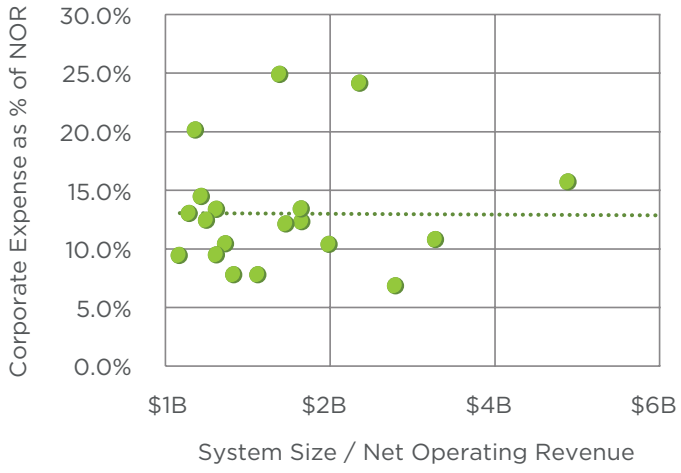
In the past two years, U.S. hospitals have experienced significant reductions in operating profits as growth in revenue has subsided into the mid-single digits. In Navigant's financial performance database, two-thirds of 104 leading health systems in the United States saw operating earnings fall in three fiscal years ending in 2017 — almost a fifth of whom experienced declines of over $100 million.[1]

Cost growth for corporate services and nonclinical functions serving both internal and external customers has been one of the key drivers of the slump — these include functions like Human Resources, Finance, Supply Chain, Marketing, and IT. Few high-performing health systems have been successful in managing the costs of corporate services. Fact-based understanding of where the problem lies is often a good beginning. However real change can come from achieving consolidation of duplicate efforts, standardization of processes, labor efficiency and process automation.

We examined in detail the financial disclosures of 21 leading U.S. health systems from July 2015 to June 2017 and found corporate expenses increased at more than twice the rate of net patient revenue. Corporate services spending varied by more than three-fold- from a low of 7% of operating expense to a high of 25% of total operating expenses (Figure 1).

Figure 1: Corporate Expense as a Percent of Net Operating Revenue by Health System



Source: Navigant Internal Database and Definitive Health (FY 2015-FY 2017)

1. Goldsmith, Stacey, and Hunter, "Stiffening Headwinds Challenge Health Systems to Grow Smarter," Sept. 2018: www.navigant.com/insights/healthcare/2018/health-systems-financial-analysis

WHAT'S DRIVING THE GROWTH IN CORPORATE SERVICES EXPENSES?

Corporate services expenditures are comprised of centralized or partly decentralized functions like information technology, marketing, finance, revenue cycle management, supply chain management, human resources, and facilities and real estate management, as well as executive office and operations management. Corporate expense spending is calculated by a census of employees at all levels — hospital, regional office, and corporate headquarters — who perform a wide range of nonclinical functions. Their salaries are grossed up to include benefits costs that can range from 30% to 45%. It also includes all the contractual expenses required to support those functions — things like IT and legal contracts and other vendor services utilized as part of those corporate functions.

Many health systems seeking market influence or improved access to capital have consolidated ownership of multiple hospitals. However, post-merger, management often hesitates to realize expected synergies at the corporate and regional levels. Some of the hesitation might be attributed to management bandwidth, inability to reduce the workforce due to cultural challenges, or the perception that the only way to drive better patient outcomes is to add more FTEs to solve the problem — versus truly transforming their business models in how they operate.

Though many mergers and acquisitions have been justified by economies of scale, we found no relationship between scale of operations (measured by adjusted admissions, total net operating revenue, or numbers of beds) and corporate expenses (see Figure 1 for net operating revenue vs. corporate expense). In our experience, corporate expenses tend to rise in the aggregate, rather than fall, after the consolidation following a merger or acquisition, due to major part to systems integration challenges and new spending for information technology (IT).

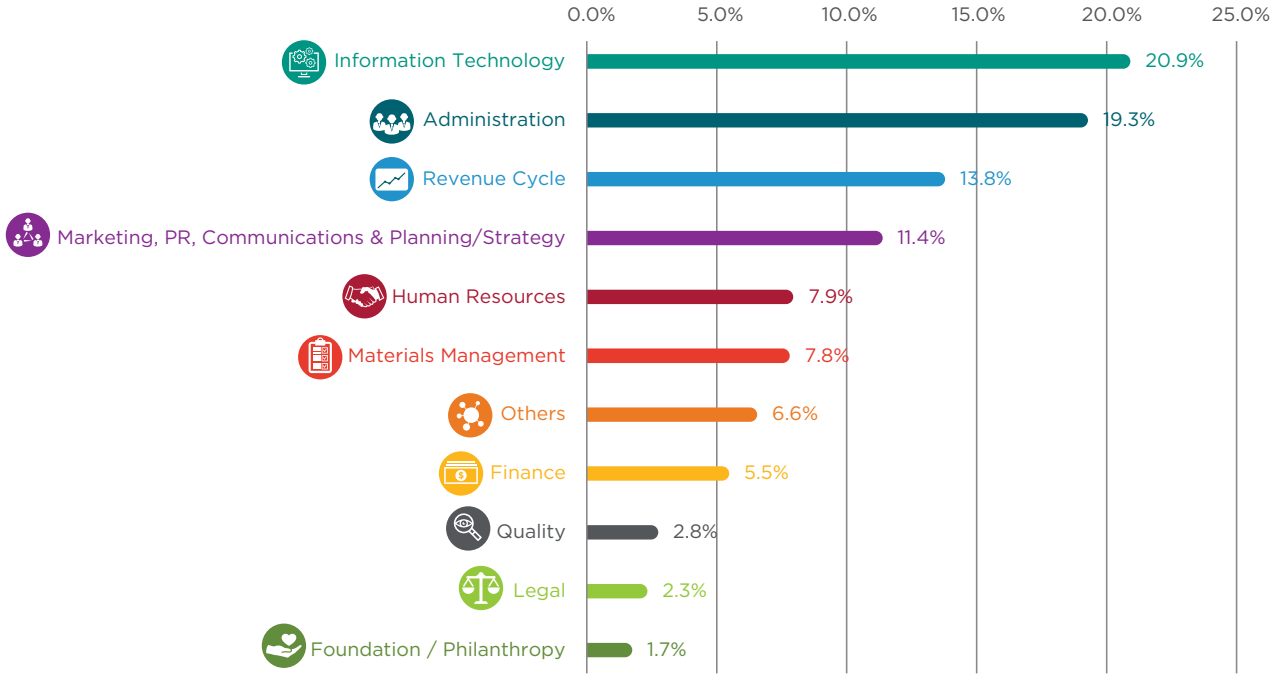
Additionally, in response to the Affordable Care Act, health systems geared up for population heath management and created dyad-based (requiring a pair of clinical and administrative executive working the same role) management roles like chief clinical/quality officer, chief analytics officer, and chief population health officer. The advent of electronic health records (EHRs) helped improve patient safety but also resulted in a structural increase in IT support spending. Rather than reducing administrative spending, EHR conversions resulted in IT becoming 25% to 35% of the entire corporate services budget.

For the most part there are four main reasons why the Corporate Services have sprawled:

- Duplication of corporate functions across the system, many because of incomplete mergers and legacy operations
- Lack of innovation around the operating model and a focus on improved delivery of services at a lower cost
- Repurposing staff instead of eliminating it after outsourcing or implementation of technology that reduces manual efforts
- Inability to take advantage of scale to better negotiate spend of purchase services

Using Corporate Expense data collected from Navigant's clients from July of 2015 to June of 2017, the most fertile areas for corporate expense reductions (Figure 2) are also the largest categories of expense: IT and general administration. The next-largest opportunities are found in revenue cycle management and marketing/strategy function. Depending on the starting point, reductions of 10% to 25% in expense can be achieved, with concomitant increases in operating income. Rationalizing corporate services outlays can make a material difference in reducing overall health costs.

Figure 2: Savings potential for typical corporate functions



Source: Navigant Internal Database. Savings percentage of baseline spend on each function (FY 2015-FY 2017)

STREAMLINED OPERATING MODEL IS ESSENTIAL TO CONTROLLING CORPORATE SERVICES EXPENSES

The key enabler to controlling corporate services spending is transforming the health system's corporate office from a holding company to an operating company model. In addition to managing corporate cost, this will also help with clinical costs. To become an operating company, corporate management will need to drive programmatic consolidation and standardization of corporate functions of all its hospitals and affiliates.

This is typically met with resistance from hospitals because they are used to controlling their destiny autonomously and will question corporate intent. In response and in the spirit of affordability, the corporate should clarify decision rights, and convince the local affiliates about importance of collective efforts to manage cost versus doing what is best for just themselves. Absent these actions, every affiliate will be in financial trouble. Dissolving or dramatically rescoping the authority of local boards can also be helpful in promoting centralized governance and decision making.

However, adopting an operating company model isn't enough. In addition there should be a fact-based evaluation of efficiency (doing same things faster) and effectiveness (doing things differently to drive better quality). Achieving workforce-related efficiency has been health systems' objective for more than a decade. Many systems have completed this journey at some level — however, changing the operating model requires bold moves that are often disruptive and uncomfortable — and many systems have fallen short. However, given the pressure on lowering the cost of healthcare these traditional efficiency efforts may not be sufficient.

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Achieving effectiveness in addition to efficiency is becoming increasingly valuable. While new to healthcare, Robotic process automation (a technique to automate repetitive manual work) combined with Artificial Intelligence (AI) will eventually eliminate tedious and repetitive jobs while improving outcomes. Scanning and indexing paper, copying and pasting data from one spread sheet to another are examples of basic tasks that are still done manually in healthsystem and should be automated. These tools have become common in highly transactional industries like financial and legal services. Hence healthcare teams often go outside the industry to acquire the necessary talent to apply these automation tools.

Systems that don't take concrete steps to improve their financial viability may face one of these four outcomes:

- Acquisition by a larger entity
- Merger with another entity
- Takeover by a private equity company
- In the worst-case, ceasing operations

In each of the above scenarios, a few things are certain: change of management, loss of community input, and uncertain relations with local medical communities.

One thing is clear to us: there is a big payoff from addressing the nonclinical elements of hospital and health system cost. In some cases, it may be that there are actual economies of scale in hospital operations. However, they are not inherent in scale itself, and can only be achieved by clarity of management purpose and stripping out layers of staff and purchased services that no longer create value.

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