Hospital Cost-Containment Strategies that Earn the Respect of Rating Agencies
Overview

• Need for awareness of areas of risk and frequent meaningful communication with rating agencies and debt holders.
• Quantitative and qualitative assessment metrics must reflect the dynamics of the changing world of healthcare delivery.
• Questions to ask of your financial and organizational structure.
• Transformative strategies for creating a cost-effective facility.

• For example, Moody’s lists the five key factors that form the basis of rating assessment for not-for-profit hospitals and health systems are:
  • Market Position
  • Operating Performance
  • Balance Sheet and Capital Plan
  • Governance and Management
  • Debt Structure and Legal Covenants
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Why is this important?

Hospital Cost-Containment Strategies
Risk Factors & Areas of Concern

• Ratings agencies increasingly concerned with how management and the board respond to the above challenges; do they have the expertise and vision to remain successful.
  • Ability to manage cost is a reflection of capable management
  • Much of the low-hanging fruit has been pruned. Further, expense reductions likely to be more difficult to realize.

• Hospital management and boards must respond to numerous influences:
  • Market forces (e.g. local competition, government regulation)
  • Changes in payor and physician relationships
  • Increase in service demand, while weathering dwindling healthcare payments
  • Value based payment regimes
  • Salary and labor demands
  • Funding capital projects while servicing debt
  • Consolidation of insurance market
  • Budgetary constraints challenge Medicaid funding

• Ability to weather market disruptions & financial storms
Quantitative & qualitative analysis

Hospital Cost-Containment Strategies
ANALYTICAL FRAMEWORK FOR STAND-ALONE HOSPITAL RATINGS

Enterprise Profile
- Industry Risk
- Economic Fundamentals
- Market Position
- Management and Governance

Financial Profile
- Financial Policies
- Liquidity and Financial Flexibility
- Financial Performance
- Debt and Contingent Liabilities

Initial Indicative Rating
- Positive Overriding Factors
  - Extraordinarily high reserves (one-notch adjustment)
  - Academic medical center with closely related high-rated university (one-notch adjustment)
  - Tax-supported hospital (up to two-notch adjustment)
- Negative Overriding Factors
  - Lack of willingness or potential bankruptcy (caps rating)
  - Credit emerging from financial crisis (caps rating)
  - Weak management (up to three-notch adjustment)
  - Extraordinarily low reserves (caps rating)
  - Limited revenue base (one-notch adjustment)
  - Specialty hospital (one-notch adjustment)

Indicative Rating
- Peer comparisons (one-notch adjustment)

Final Rating

Source: Standards & Poor's, U.S. Not-for-Profit Acute-Care Stand-Alone Hospitals—Methodology and Assumptions, December 2014. Used with permission.
Quantitative Evidence

• Salary and expenses as a percentage of revenue
  • Higher rated organizations carry less personnel cost as a percentage of NPR.
  • For S&P, the difference between AA and BBB medians was ~ 5%

• Bad debt expense – fell nationally in 2014 as the uninsured rate fell as a result of Medicaid expansion.

• Average age of plant and depreciation
  • 2014 the first year CAPEX as a % of depreciation dropped significantly below 100% for BBB & lower organizations
Qualitative Factors

• Hospital Management Capability
  • Including support of the Board of Directors
  • Management and Governance must be united in mission

• Facility’s standing in the community
  • Responding to local medical needs
  • Response to competition
  • Cooperation/integration with payors and/or physician organizations

• Capital planning – Long term View
  • Find growth opportunities
  • Return on investment
  • Manage balance sheet for optimum results

• Government / Disproportionate Share
  • Participate in DSH programs
  • Grant funding where possible
Transformative Strategies

Hospital Cost-Containment Strategies
Mergers, Affiliations & Partnerships

• Notable benefits:
  • Improved volumes, ability to attract & retain physicians, and / or ability to maintain referrals → revenue driving
  • Increased ability to reduce expenses (reduced overhead and management; ability to negotiate with suppliers / vendors) → economies of scale
  • Broader market to implement population health strategies and new delivery models

“Fitch believes consolidation activity will likely continue, albeit at a slower pace, as management refocuses efforts toward physician alignment and optimizing its clinical delivery model. The market is increasingly more favorable to integrated systems with several hospitals, a wide network of outpatient facilities, broad physician base and health plan capabilities.”
Shift to Outpatient Care

- Moody’s started monitoring outpatient to inpatient revenues
  - Moving care to most cost-effective and clinically appropriate setting
  - Technological advancements make it possible to deliver higher levels of care in an ambulatory environment

Source: Moody’s Investors Service
Physician Integration

• Acquiring or Affiliating with a physician or practice can depend on plans and local market scenario.

• Acquisition can increase costs short-term.

• Can management explain how physician integration will affect costs, revenue, and market share in long-term?

• Use of hospitalists and intensivists are becoming the standard of care; quality and resource utilization are likely to improve with this model.

• Short of acquisition, sharing the EHR is also becoming the standard of care.
Service Line Adjustments

• Active cost accounting is absolutely essential to understanding the hospitals products and services.

• Understanding service costs and directly benefit better reimbursement:
  • Look for a pattern of denials
  • Price new services, changes to patterns of use
  • Work with physician case management on areas of concern

• Agencies will focus on unprofitable service lines, especially if other local facilities offer the same.

• For example, various intensive surgical specialties are not as crucial depending on the market – evaluate cost/benefit and community need.
Personnel Costs

• Salary and Wages are anywhere from 50 to 60% of total expenses.

• Controlling personnel costs:
  • Manage hours per unit of service (e.g. hours per patient day)
  • Set goals for hours per unit of service and communicate with department management
  • Limit overtime (explore better use of the nursing float pool)
  • Use the budget process to highlight proper staffing

• Be prepared to understand & explain all personnel-related expenses:
  • Another factor is the control of indirect costs
  • Staffing for weekends and evening shifts (limit call-offs)
  • Benefits planning and pension costs are truly significant

• Underfunded pensions can be worrying – consider changing from defined benefit plans to defined contribution plans, and/or moving excess cash flow into pension accounts.
Potential Results & Final Considerations

Hospital Cost-Containment Strategies
Potential Positive Results

• Cash is still king, and days cash-on-hand is still a reliable metric.
• Business office dynamics are key to success
  • Managing AR days by payor
  • Proper mix of in-house bill collecting and use of out sourced vendors (early out, managed care review, placement after a fixed time to work in-house)
  • Use cost accounting / product contribution to look for payment trends including short pays and denials, etc.
• Payers and other providers will be more inclined to partner with hospitals that can provide lower-cost, high-quality care. Ability to partner in today’s marketplace is essential to building a continuum of care.
  • Payment terms must be agreeable to both provider and payor (to eliminate unnecessary denials).
  • Monthly or quarterly JOC (joint operating committee) with major payors is essential to keep proper payments flowing.
Antelope Valley Hospital

Background

• Antelope Valley Hospital is a 420-bed acute care regional medical center organized under the guidance of the Antelope Valley Healthcare District (the District) in the city of Lancaster in northern Los Angeles County.

• Lancaster Pollard previously underwrote tax-exempt bonds for the District in 2011, which were used to finance a capital improvement plan including the renovation and expansion of certain facilities. The 2011 bond issue followed a 2010 private placement tax-exempt issue, which funded seismic improvements that were necessary due to a California law that requires all hospitals to achieve compliance status by 2018.

• Management sought to refinance the bond issues from 2010 and 2011, as well as bond issues from 1997 and 2002, into one debt structure. Refinancing would eliminate a $55 million balloon payment on the District’s existing debt due in September 2017 and ultimately strengthen the hospital’s capital structure.

Challenges

• The hospital experienced challenges in the below expense areas that needed to be addressed before going to market:
  • Supply expenses
  • IT
  • Overtime
  • Salaries and wages as a percentage of revenue
  • Seismic compliance challenges with the physical plant
Financial Solution

- Lancaster Pollard determined it was in the hospital’s best interest to multi-track the deal and pursued the FHA 242/223f program, along with public bonds. Due to several challenges, including a downgrade in the district’s rating and management turnover, it was determined that the FHA 242/223f program would not be feasible.
- Time was of the essence due to the impending $55 million balloon payment. When bond markets became more appealing, Lancaster Pollard was able to quickly adapt and orchestrated a public bond deal under favorable market conditions.

Outcome

- Lancaster Pollard and the District closed at a favorable rate and the $140 million Series 2016A bonds will reach final maturity in 2046. The hospital will use $10.4 million of project funds to complete the necessary seismic improvements in order to meet California’s compliance standards by 2018. The refinancing also reduced the hospital’s debt service coverage covenant to 1.2x and reduced the days cash on hand covenant to 55.
- Ultimately, by refunding the District’s four existing bond issues into one debt structure, Lancaster Pollard was able to greatly improve the hospital’s capital structure and covenant package and position them well for the future.
Questions to Ask

1. Is the cost-containment strategy viable, not just for a few years but for the next decade?
2. What does a viable strategy look like?
3. Is the organization focused on process improvements and transformational changes that will improve vital outcomes, including length of stay, patient satisfaction, and readmissions?
4. Are Value Based payments structures being evaluated?
5. What cultural factors must be addressed (e.g. unions, community needs)?
6. How might cost cut be corrosive to the organization or harm patients?
7. Supply chain management can provide immediate positive results (e.g. physician preference items are always subject to local bidding)
Final Thoughts

• Ratings are not perfect, but they do convey a direction and discipline.
• The management team and board must be educated on the rating agency process.
• Physician and lay board members need to better understand their roles with the rating agency process.
• In the final analysis, the community takes great price in its bond rating (if positive).
• Ratings do not go unnoticed; local newspapers and business publications will document any change in rating.
• Frequent communication between the hospital and the rating agency on trends and metrics is desirable.
• Agencies should be aware of hospital goals and the reported results.
• Personal visits by the rating agencies should be encouraged.
QUESTIONS?
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