The Academy

The Health Management Academy

Strategic Survey Q4 2019: Margins, Consolidation & Partnerships

December 2019

Margins, Consolidation & Partnerships

Introduction

Leading Health Systems (LHS) are increasingly experiencing pressure on their operational margins due to a variety of factors including the role of public payers, the increasing cost of delivering care, and the digital revolution, among other factors. This margin pressure has significant implications for health systems' strategic planning and decision-making, and informs LHS' approach to consolidation and partnership activity.

In this report, The Health Management Academy (The Academy) explores the impact of health system margins on consolidation and strategic partnership opportunities.

Methodology

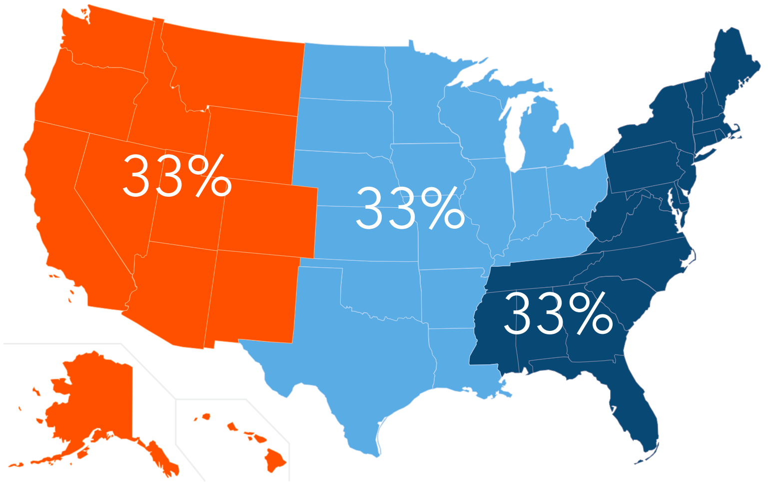
In October and November 2019, The Academy conducted the twenty-first round of phone interviews for its quarterly strategic survey among LHS executives, including: CEOs, COOs, CFOs, CMOs, CNOs, and CSOs.

The survey for the interview consisted of:

1. A tracking section that provides insight into trends around primary strategic areas; and
2. A special topic area that allows for an in-depth look into a timely developing issue.

Profile of Participating Health Systems

Representative of the U.S. Regions



MEDIAN REVENUE $3.6 BILLION

OWN OR OPERATE 197 HOSPITALS WITH 39,106 BEDS

SINGLE-STATE SYSTEMS: 47%
MULTI-STATE SYSTEMS: 53%

Key Findings

1

Cost & Margins

Nearly 40% of health systems expect their margins to decrease in 2020, with many citing the increased proportion of revenue from government payers representing a top concern.

2

Consolidation

Approximately half (56%) of health systems made an acquisition in Q3 2019, all of which acquired at least one physician practice.

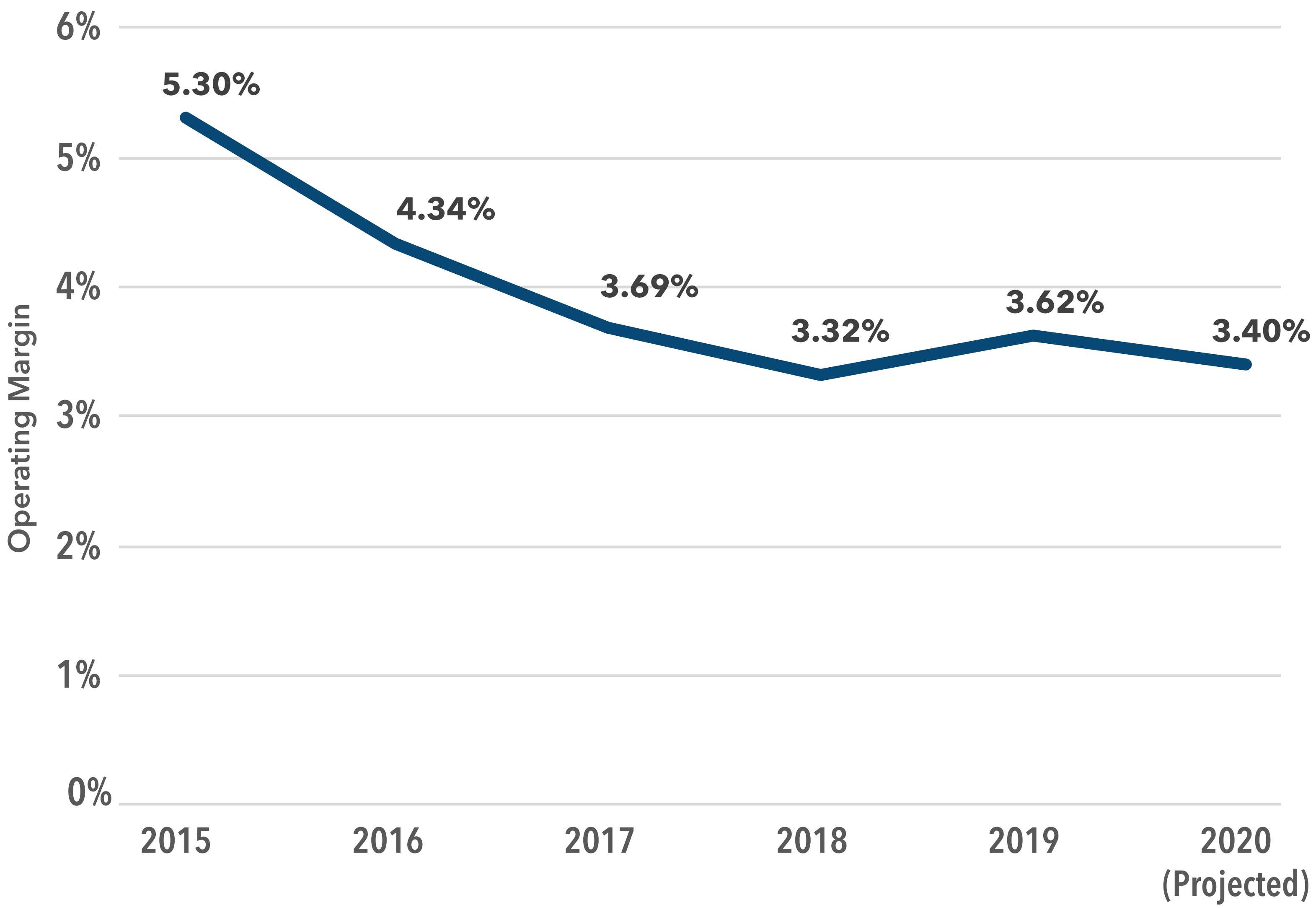
3

Strategic Partnerships

Two-thirds of health systems plan to form strategic partnerships in Q4 2019 and Q1 2020, with 40% of those health systems focused on both provider and industry partnerships.

Operating Margin Is Eroding Across LHS Landscape

LHS Average Operating Margin



Note: Participating systems may vary by quarter.

Average Margin Down Almost Two Percentage Points in Five Years

Health system operating margins have steadily declined over the last five years, decreasing from an average of 5.30% in 2015 to 3.62% in 2019. Forecasted operating margins are expected to continue to decrease to an average of 3.40% in 2020.

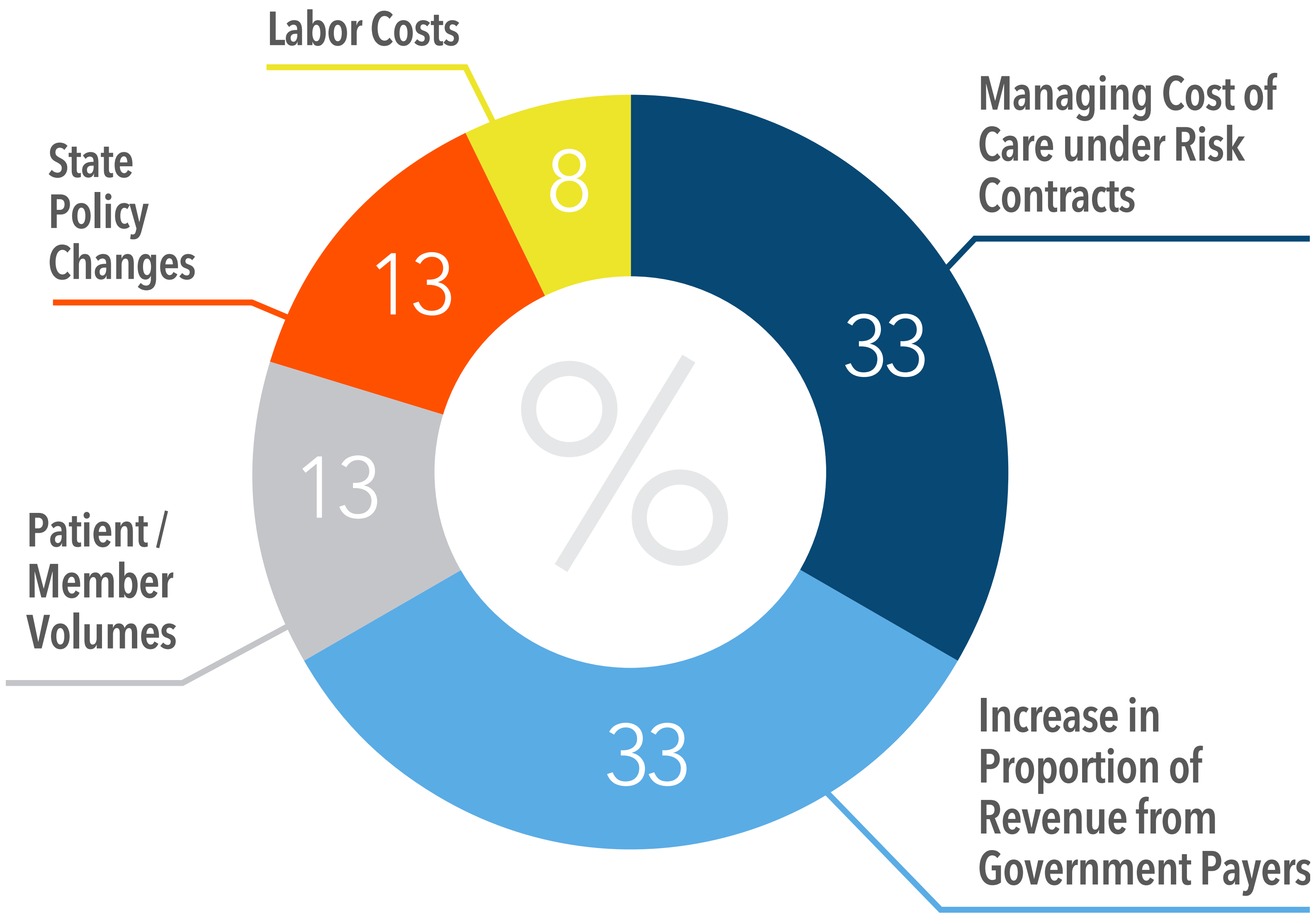
Strategies to Maintain Margins Involve Revenue Growth and Cost Reduction

As margin pressures intensify, health systems are pursuing new revenue streams and prioritizing operational effectiveness to sustain financial viability. In terms of revenue growth, LHS are focused on innovation and implementing new business lines, expanding service line, growing the pharmacy business, and broadening digital offerings.

LHS are also highly focused on improving operational efficiency and cost management, commonly through investment in labor and technology, reducing clinical variation and unnecessary utilization, optimizing throughput, leveraging telehealth and low-cost settings, and streamlining the supply chain.

Cost of Care and Government Payers are Greatest Margin Risks

Greatest Risk to LHS Margin



External Forces Pose Greatest Risks

As health systems forecast their 2020 margins, 38% of systems expect their margin to decrease, 31% expect their margin to increase, and 31% expect their margin to stay the same. However, several health systems that anticipate decreasing margins in 2020 expect their margins to increase again in 2021.

LHS view the greatest risks to their margins as primarily involving reimbursement structures, including the increase in the proportion of revenue from government payers (33%) and managing the cost of care under risk contracts (33%). Other risks included patient/member volumes (13%), state policy changes (13%), and labor costs (8%).

"The increase in government payer revenue and decrease in commercial revenue is a risk – and the decrease in reimbursement rates among government payers is the major risk." – CNO

Reinvestment is the Primary Consideration for Margins

71% of C-suite executives agree that

3-4%

is a healthy operating margin for their health system

"If our margin gets above 5%, we start to get uncomfortable because it means we've overcharged the market. So we hold margins down by investing in the future or restoring dollars back into the community." – CFO

LHS Executives Not Aiming for Margin Maximization

"Of course everyone would like to have fantastic margins, but I think 3-4% is the level at which we're able to reinvest." – CNO

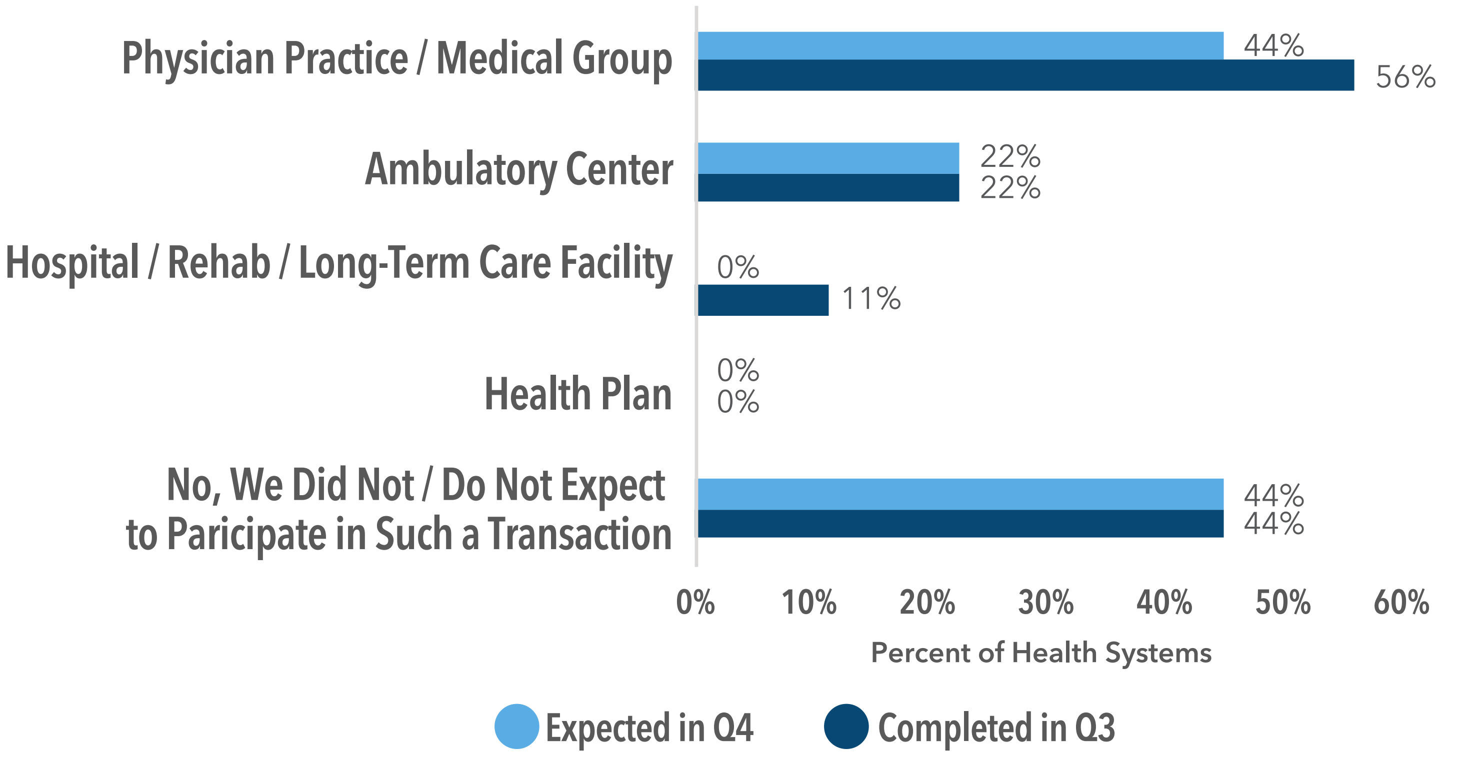
As LHS consider optimal margins, 71% of C-suite executives agree that 3-4% is a healthy operating margin for their system. Nearly all health system executives noted their goal is not to maximize margins, but to sustain margins at a level which allows the health system to re-invest in infrastructure, innovation initiatives, and the community.

Particularly as mission-driven not-for-profit organizations, health systems are focused on maintaining a margin that allows them to keep costs down and reduce patient prices. However, executives note maintaining a margin in the 3-4% range is still a challenge in an environment of rising costs and declining reimbursement.

"Margin maximization is not our goal. We are trying to lower the cost of care and push to disrupt ourselves." – COO

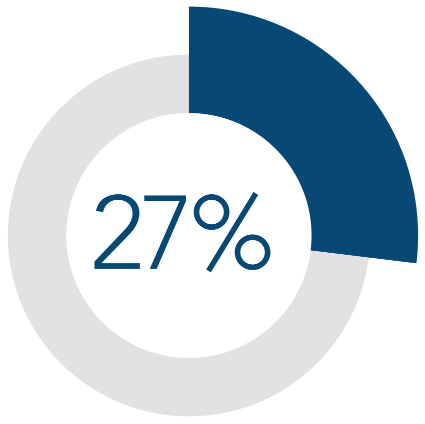
LHS Expect Continued M&A and Partnership Activity

Q3 and Expected Q4 2019 Acquisitions

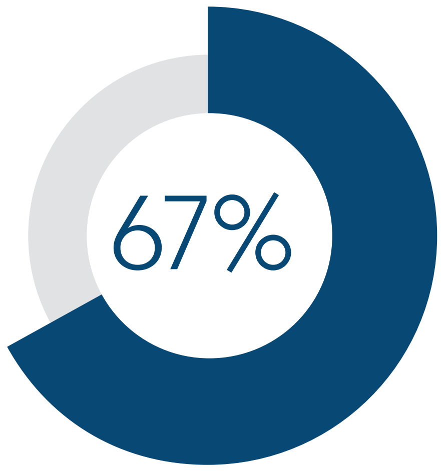


Acquisition Activity Remains Focused on Physician Practices

Approximately half (56%) of health systems completed an acquisition in Q3 2019, all of which acquired at least one physician practice. The trend of acquiring physician practices and medical groups has been consistent over the last several years, reflective of LHS priorities to grow their employed medical groups. LHS expect this trend to continue, with 44% of executives anticipating acquiring a physician practice in Q4 2019.



27% of LHS Completed a Partnership in Q2 – Q3 2019



67% of LHS Expect to Complete a Partnership in the Next 6 Months

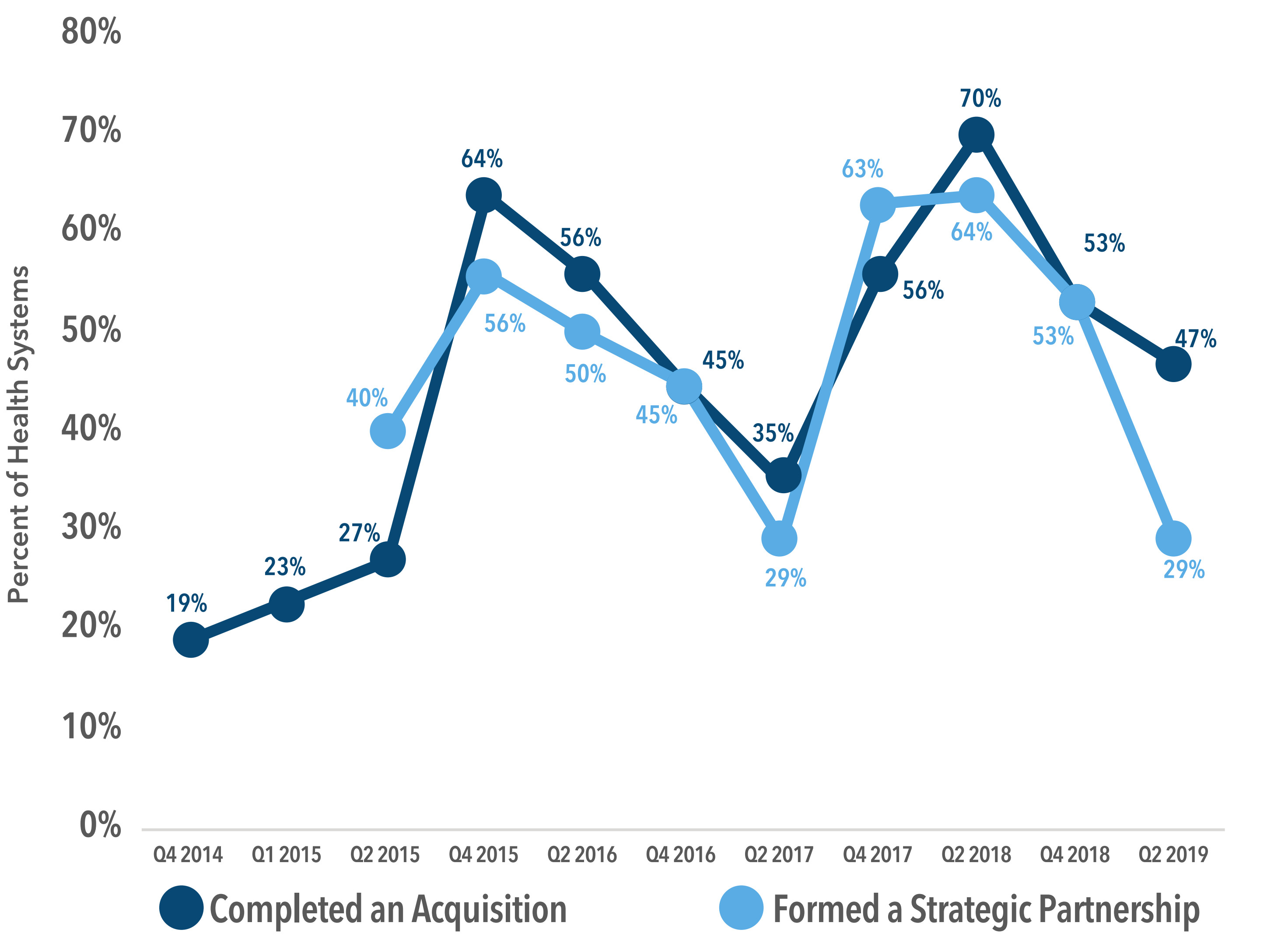
Partnership Activity Fluctuates among LHS

Partnership activity among LHS fell in Q2-Q3 2019, with 7% of LHS forming a partnership with another provider organization and 21% forming an industry partnership. However, health systems expect partnership activity to increase, with 67% of systems citing plans to form strategic partnerships in Q4 2019 and Q1 2020.

Among systems with planned partnerships, 40% intend to form both provider and industry partnerships, 20% provider-only, 20% industry-only, and 20% other/unspecified. Areas in which LHS are planning to form provider partnerships include specialty hospitals and developing service line synergies. The focus of industry partnerships includes supply chain, clinical services, IT, health plans, and retail-based partnerships. Other partnerships areas included population health and value-based care.

Cyclical M&A and Partnership Activity among LHS

Acquisition and Partnership Activity, 2014 - 2019



Margins Inform, but Do Not Dictate M&A or Partnership Activity

Despite continued downward pressure on LHS margins, health systems have remained fairly cyclical in engaging in M&A and partnership activities. While margin performance impacts an acquisition or partnership decision, executives indicate it does not drive the discussion.

As C-suite executives consider the impact of health system margins on partnership opportunities, many agreed that maintaining a healthy margin is key to being an attractive strategic partner. LHS see the value of partnerships as expanding or enhancing existing capabilities, driving value through economies of scale, and achieving the organization's mission. Additionally, several executives cited a willingness to take short term, upfront losses in their operating margin if a strategic partnership was expected to have a longer term positive impact on margin.

The number one factor health systems consider in a partner is strategic fit and alignment with their organization. Executives consistently cited plans to look for like-minded partners that help them achieve strategic mission, vision and goals.

"Because we have a strong balance sheet, we look at M&A and partnership activity as *'What supports mission growth?'*" –COO

Note: Participating systems may vary by quarter. Partnership data was not collected prior to Q2 2015.

About the Academy

The Health Management Academy (The Academy) is a membership organization exclusively for executives from the country's Top-100 Health Systems and most innovative healthcare companies. The Academy's learning model identifies top priorities of health system leaders; develops rich content based on those priorities; and addresses them by convening members to exchange ideas, best practices, and information. The Academy is the definitive trusted source for peer-to-peer learning in healthcare delivery with a material record of research and policy analysis. Offerings include C-suite executive peer forums, issues-based collaboratives, leadership development programs, research, advisory, and media services. The Academy is an accredited CE provider. More information is available at hmacademy.com.

The Academy Project Team

Victoria Stelfox
Senior Analyst, Research & Advisory

James Cheung
Associate, Research & Advisory

Ali Joseph
Coordinator, Research & Advisory

Matt Devino
Senior Analyst, Research & Advisory

Melissa Stahl
Senior Manager, Research & Advisory

Sanjula Jain, Ph.D.
Executive Director, Research & Advisory

About Lumeris

Lumeris is a value-based care managed services operator for health systems and providers seeking extraordinary clinical and financial outcomes. Lumeris aligns providers and payers across populations with technologies, processes, behaviors and information to achieve high-quality, cost-effective care with satisfied consumers – and engaged physicians. Lumeris with Essence Healthcare, its inaugural client with more than 60,000 Medicare members in Missouri and Illinois, has averaged a CMS rating of 4.5 Stars for the last ten years and produced the highest consumer and physician satisfaction scores in the industry along with significantly better clinical outcomes and lower costs. For more information, go to www.lumeris.com.

The Health Management Academy extends its appreciation to Lumeris for the financial support for this project.

