

# Ensuring The Best Use of Limited Capital

## *2012 MEGA Conference*

Wisconsin Dells, Wisconsin / January 20, 2012

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# Agenda

- The New World
- Quantifying Capital Availability
- Optimizing the Capital Allocation Process
- Summary and Conclusions
- Questions and Discussion

# The New World

## The Word of the Moment in Healthcare Is “Unsustainable”

As in:

- The size of the federal budget deficit is unsustainable
- The annual increase in the Medicare budget is unsustainable
- The percentage of healthcare spending to GDP is unsustainable
- State Medicaid programs are unsustainable
- The continued transfer of costs to employers and consumers is unsustainable

## Consequently, the Market Is Transforming

Unsustainability of the Current Financial Platform



New Business Model



Critical Themes and Trends



Required Organizational Tactics



Strategic Goals and Objectives for the New Era

- Federal and state deficits
- Medicare budget
- Healthcare's % of GDP
- Cost shifting to commercial payers

- Value proposition
- Declining price
- Flat to declining utilization
- Payment change
- Continuum services
- Scale

- New entrants
- Transformational technology
- Rapid consolidation
- Accountability
- Patient management

- Branding
- IT
- Physician strategies
- Maximize scale
- New payment models

- Unrelenting innovation
- Solve manufacturing problem
- Solve variability of care
- Real cost structure management

## Transitioning to the New Business Model

	<b>Current business model</b>	<b>New business model</b>
<b>Value proposition</b>	More market share, more patients, more services, more revenue	Best possible quality at lowest possible price while keeping your margin
<b>Direction of price</b>	Saks Fifth Avenue	Wal-Mart
<b>Cost environment</b>	Cost management	Cost structure
<b>Direction of utilization</b>	Always up since 1966; growth industry	Flat/ maybe down? Mature industry
<b>Relationship between hospital and doctors</b>	Parallel play	Highly coordinated and integrated
<b>Payment</b>	Fee for service	Something else
<b>System of care</b>	Patient services	Patient and population management
<b>Importance of scale</b>	Small and medium – hospitals could survive	Big, bigger and biggest

## Our Point of View: Business Model Already Profoundly Changing

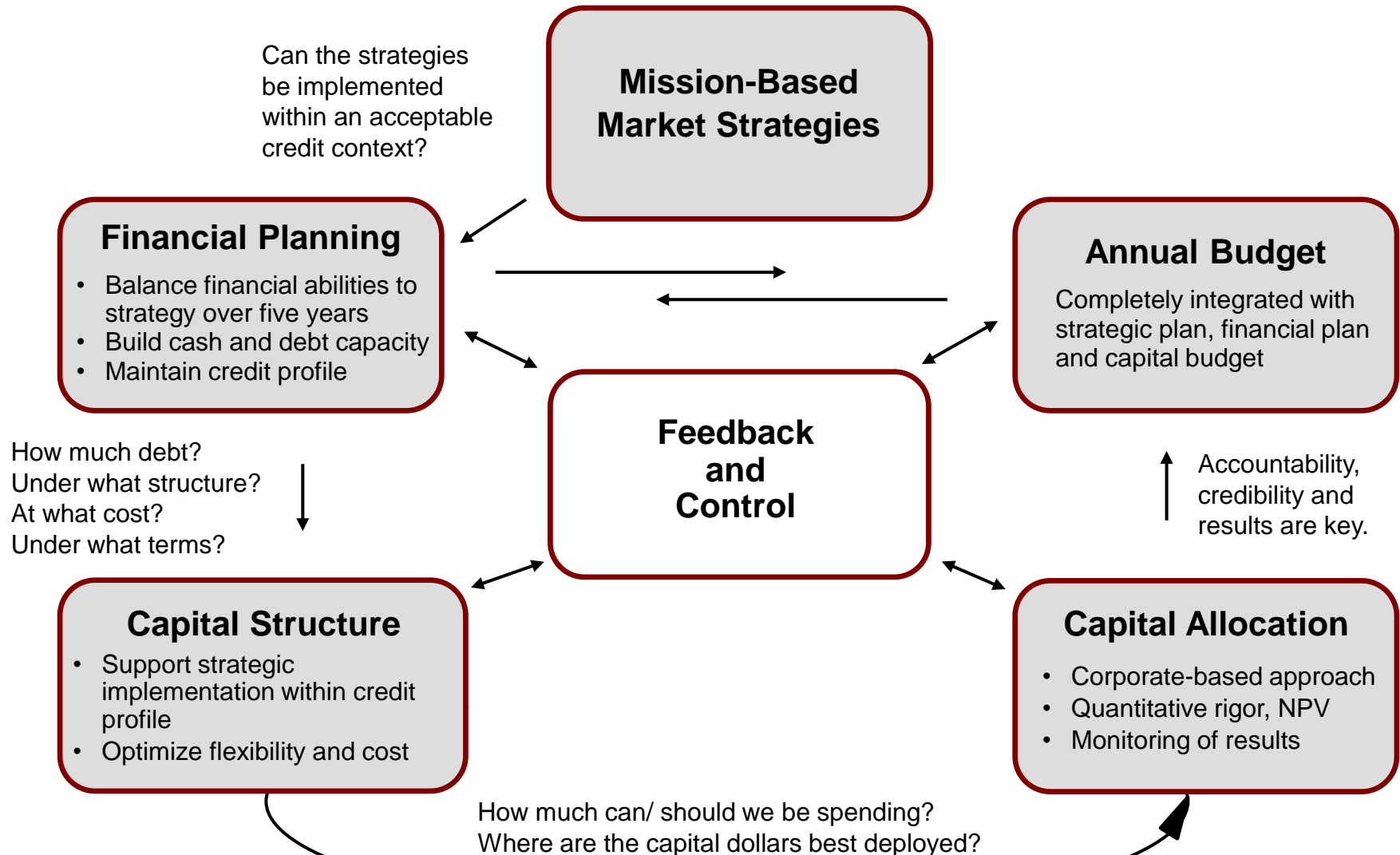
1. Healthcare is moving rapidly from a post-Medicare business model to a post-reform business model
2. Reimbursement will decline over time either on a “relative” or a “real” basis
3. The basic relationships and care model between hospitals, doctors, and patients will change dramatically
4. Technology will become a major disruptive change agent in healthcare as it has been in other industries
5. Financial strength matters, as capital capacity, access and cost will differentiate who can compete, take risk and align/ integrate/ consolidate their market

# Quantifying Capital Availability

## Regardless of Industry Change, It's Still About Fundamentals

- A disciplined, corporate finance approach remains the most effective means to determine capital availability and appropriate allocation
  - Rigorous analytics
  - Broad-based management involvement
  - “Good” bureaucracy
  - Consistent, transparent application of techniques and outcomes
- Integration of key decision making processes is vital to successful deployment of an organization's capital resources
  - Strategic planning
  - Financial planning
  - Operating budget development
  - Capital allocation

# Integrated Management Supports Effective Capital Deployment



## Determining Cash Available for Capital is Straightforward

	2011	2012	2013	2014
Operating Income	\$ 57,497	\$ 67,850	\$ 75,710	\$ 82,429
Add: Non-Operating Income (excl. interest)	-	-	-	-
Depreciation, Amortization & Loss on Disposal	67,145	68,804	71,843	75,395
Operating Cash Flow	124,642	136,654	147,553	157,824
Plus: New Debt Proceeds (net of restriction)	-	-	-	-
Non-Income Statement Philanthropy	-	-	-	-
Interest Income	28,209	29,592	31,408	33,579
<i>Total Sources of Cash Available for Capital</i>	<u>152,851</u>	<u>166,246</u>	<u>178,961</u>	<u>191,403</u>
Less: Working Capital Requirements	(3,654)	(3,201)	(3,089)	(3,050)
Principal Payments	(11,108)	(17,812)	(8,369)	(8,274)
Other Sources/(Uses) of Cash	(4,700)	(4,700)	(4,700)	(4,700)
Carryover Capital <sup>(1)</sup>	(16,163)	(26,380)	(11,003)	-
Pre-Committed Capital	-	-	-	-
Contributions to Cash Reserves	(32,013)	(19,125)	(28,777)	(28,174)
<i>Total Uses of Cash Available for Capital</i>	<u>(67,638)</u>	<u>(71,218)</u>	<u>(55,938)</u>	<u>(44,198)</u>
<i>Total Cash Available for Capital</i>	<u>85,213</u>	<u>95,028</u>	<u>123,023</u>	<u>147,205</u>
Less: 10% System Capital Contingency	(8,521)	(9,503)	(12,302)	(14,721)
Pre-Planning Contingency	(1,000)	(1,000)	(1,000)	(1,000)
<b>Net Cash Available for Capital Allocation</b>	<b><u>\$ 75,692</u></b>	<b><u>\$ 84,525</u></b>	<b><u>\$ 109,721</u></b>	<b><u>\$ 131,485</u></b>
<b>Total Capital Spending<sup>(2)</sup></b>	<b><u>\$ 101,376</u></b>	<b><u>\$ 121,408</u></b>	<b><u>\$ 134,026</u></b>	<b><u>\$ 147,205</u></b>

Note 1 – Timing of carryover capital based on current approved capital plan.

Note 2 -- Includes Cash Available for Capital Allocation, Carryover Capital, and Pre-Committed Capital.

# Optimizing the Capital Allocation Process

## What Is Capital Allocation?

- The strategic decision-making process by which an organization deploys its scarce capital resources (cash and debt capacity) for:
  - Investments to support the organization's mission and community-based imperatives
  - Strategic investments in service line/ program growth, physician initiatives, and new businesses/ ventures
  - Routine infrastructure investments in the organization's property, plant, and equipment
  - Reinvestment as cash reserves on the organization's balance sheet to fund a competitive liquidity position
  - Investment in information technology
- Tracking and monitoring ongoing capital procurement and spending

## Capital Allocation Is an Inherently Complex and Visible Process

- Proposals emerge from multiple points of origin
  - Department initiatives
  - Service line planning
  - Physician initiatives
  - Clinical technology assessment
  - Information systems
  - Facilities/ infrastructure maintenance management
  - Strategic planning
  - External regulatory/ code requirements
  - Market-driven opportunities

# Capital Allocation – A Complex Process



## Capital Allocation is Often a Highly Political Process

- Multiple constituencies have a real or perceived stake in the success of various proposals
  - Board
  - Senior management
  - Physicians
  - Department management
  - Community
- The result is the real potential for politically driven chaos that can limit an organization's ability to make optimal investment decisions
  - In the current environment, suboptimal decision making has direct and material impacts on organizational sustainability
  - A comprehensive, structured process is the best means to bring order to this complexity

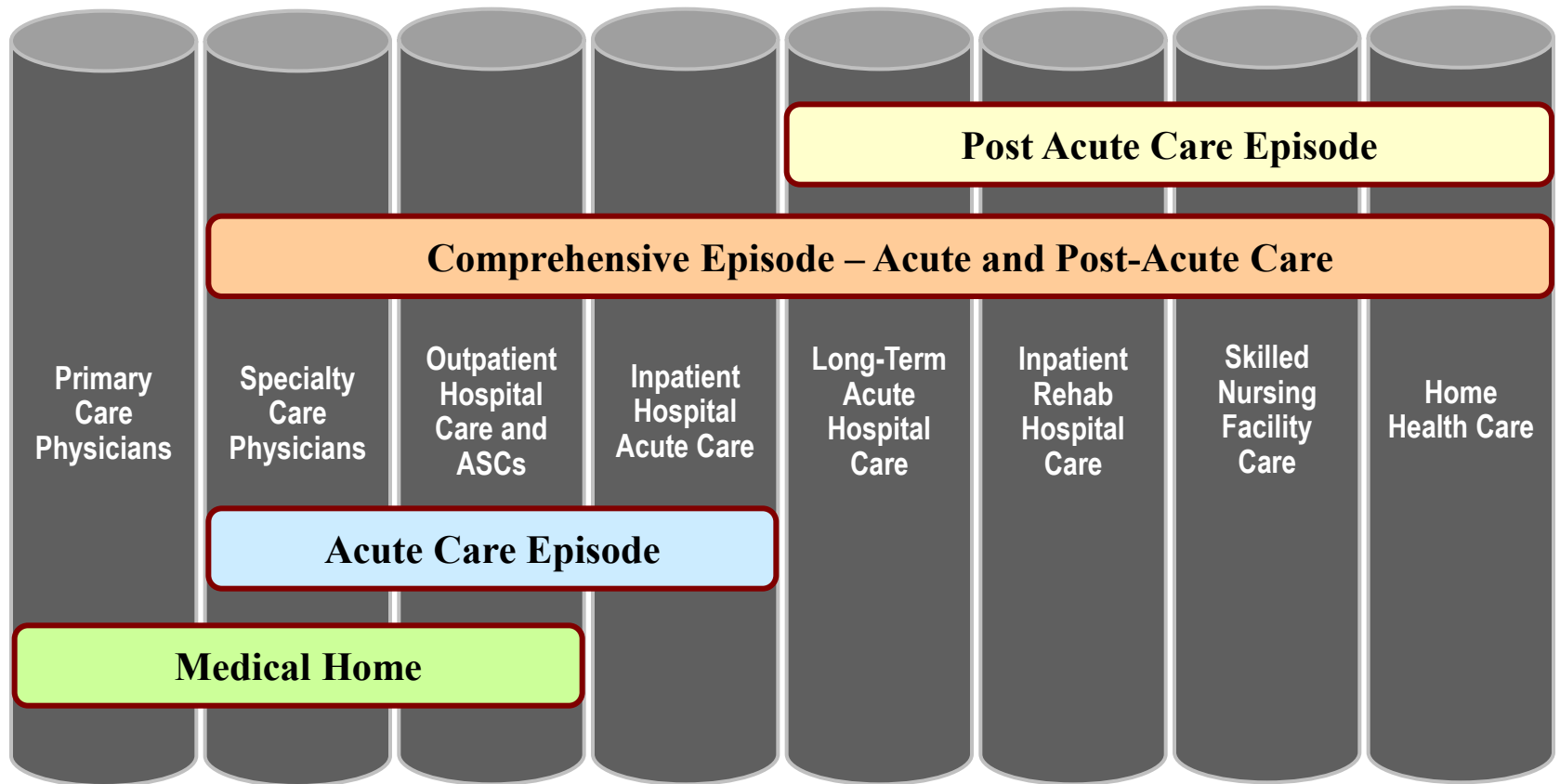
## A Best Practice Foundation Lies in the Definition of “Capital”

- The definition of capital determines the purview of the process and its requirements
- This concept is often confused with accounting definitions (e.g., all assets over \$5,000 are capitalized)
- Within the capital allocation process, “capital” .....
  - Requires analytic support before it is approved/ funded
  - Is highly visible to the organization
  - Has associated accountability
  - Includes the complete range of organizational requirements, including infrastructure, strategic initiatives, technological advances, and community benefit

## Defining “Capital”

- The typical allocation process is founded on a limited definition of capital, often based on accounting definitions
  - Facilities
  - Equipment (including IT)
  - Property
- This reflects an historical focus on fixed-asset needs, building capacity, and acquisition of state-of-the-art technological capability
  - Growth as a strategic objective
  - Focus on a singular component of the care process

# The New Era Requires a More Comprehensive Organizational Focus on Managing Total Episodes of Care



Source: American Hospital Association

# Integrating Strategic, Financial, Capital, and Operational Planning Has Never Been So Critical

	Attributes	Key characteristics of the best prepared
<b>New focus areas</b>	<b>Care coordination capability</b>	Use of care coordination tools and processes by an empowered and integrated workforce that manages costs and meets performance goals that are regularly measured and reported
	<b>Physician integration</b>	A highly aligned medical staff characterized by outcome-based contractual arrangements, informed planning, and adequate representation in organizational governance
	<b>Service distribution system</b>	A rational service distribution system that has accessible primary care, easy access (both physically and through referrals) across the care continuum, and contemporary facilities and equipment
	<b>Information systems sophistication</b>	An IT platform that supports clinical decision making, information management, and access by all stakeholders (physicians, patients, administration) to proper treatment and strategic decision making
<b>Traditional focus areas</b>	<b>Cost transformation</b>	A right-sized organizational cost structure, characterized by appropriate levels of staffing, capital spending, and supply chain costs; constant review of costs based on comparative peer group studies and benchmarks
	<b>Capital capacity</b>	Strong appeal to capital markets through sustained operations, revenue growth, and balance sheet strength
	<b>Scale</b>	Sufficient scale in the market to attract competitive clinical and administrative talent, realize economies, drive marketplace innovation, and be an essential provider to health plans and patients

## With New Competencies Come New or Expanded Funding Needs

Attribute	Funding requirements
<b>Care coordination capability</b>	<ul style="list-style-type: none"> <li>• Software acquisition</li> <li>• Staff resource expansion</li> </ul>
<b>Physician integration</b>	<ul style="list-style-type: none"> <li>• Practice acquisition</li> <li>• Practice subsidization</li> <li>• Joint ventures/ co-management</li> </ul>
<b>Service distribution system</b>	<ul style="list-style-type: none"> <li>• Ambulatory facility expansion</li> <li>• Comprehensive diagnostic capability</li> <li>• Primary care network development</li> </ul>
<b>Information systems sophistication</b>	<ul style="list-style-type: none"> <li>• Computerized physician order entry (CPOE)</li> <li>• Electronic health record (EHR)</li> <li>• Physician systems integration</li> </ul>

## An Expanded Definition of “Capital” Is Also Required

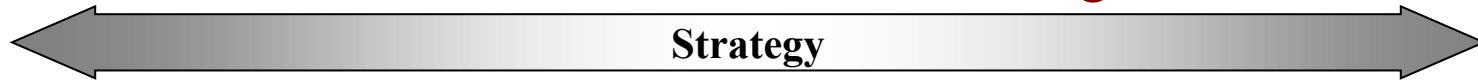
- While the traditional definition still holds.....
  - Facilities
  - Equipment (including IT)
  - Property
- Expanded business requirements demand a more inclusive definition
  - Business acquisitions and partnerships
  - Network development
  - Program start-up subsidies
  - Physician recruitment
  - Physician joint venture management arrangements
  - System initiatives (multi-hospital organizations)
  - New programs or services

## Why Expand the Definition of Capital?

- Providers have increasing demands for operating subsidization of new programs or physician-related strategies
- Vendor-based capital acquisitions are often clouded by unique and/or creative financing mechanisms
- Changing strategic needs and direction can displace basic infrastructure requirements (including facilities and programs)
- Introduction of health reform-related requirements will create the need for new business structure development and funding

**In the end, it comes down to cash flow**

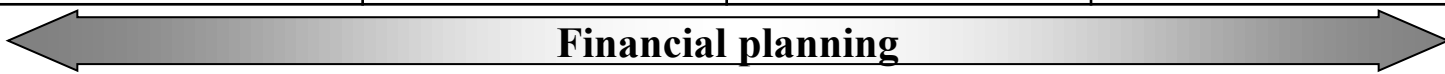
# Expanding the Purview of the Capital Process Also Enables Key Questions to Be Answered within a Broad Planning Context



What will be required to succeed?

What is our current position and where do we need to go?

<b>Core competencies</b>	<b>Provider integration strategies</b>	<b>Growth and scale</b>	<b>Capital/ risk</b>	<b>Access/ resource use</b>
	<ul style="list-style-type: none"> <li>• How will the organization of care delivery change?</li> <li>• With which networks and ACOs do we need to align?</li> <li>• How do we develop sustainable hospital-physician arrangements?</li> </ul>	<ul style="list-style-type: none"> <li>• Do we have sufficient size and scale?</li> <li>• What is our strategy for growing?</li> <li>• How will reform impact our numbers?</li> </ul>	<ul style="list-style-type: none"> <li>• How do we access capital at an appropriate level of risk?</li> <li>• How much can we afford to spend?</li> <li>• How can we most effectively manage our capital structure?</li> <li>• What are our risks? How can we mitigate such risks?</li> </ul>	<ul style="list-style-type: none"> <li>• Is our cost structure competitive? If not, what needs to change?</li> <li>• Are we allocating capital effectively?</li> <li>• Which services should we be offering in which locations?</li> <li>• Is the right complement of business units and assets in place?</li> </ul>



## Solid Analysis Remains the Foundation for Comprehensive Decisions

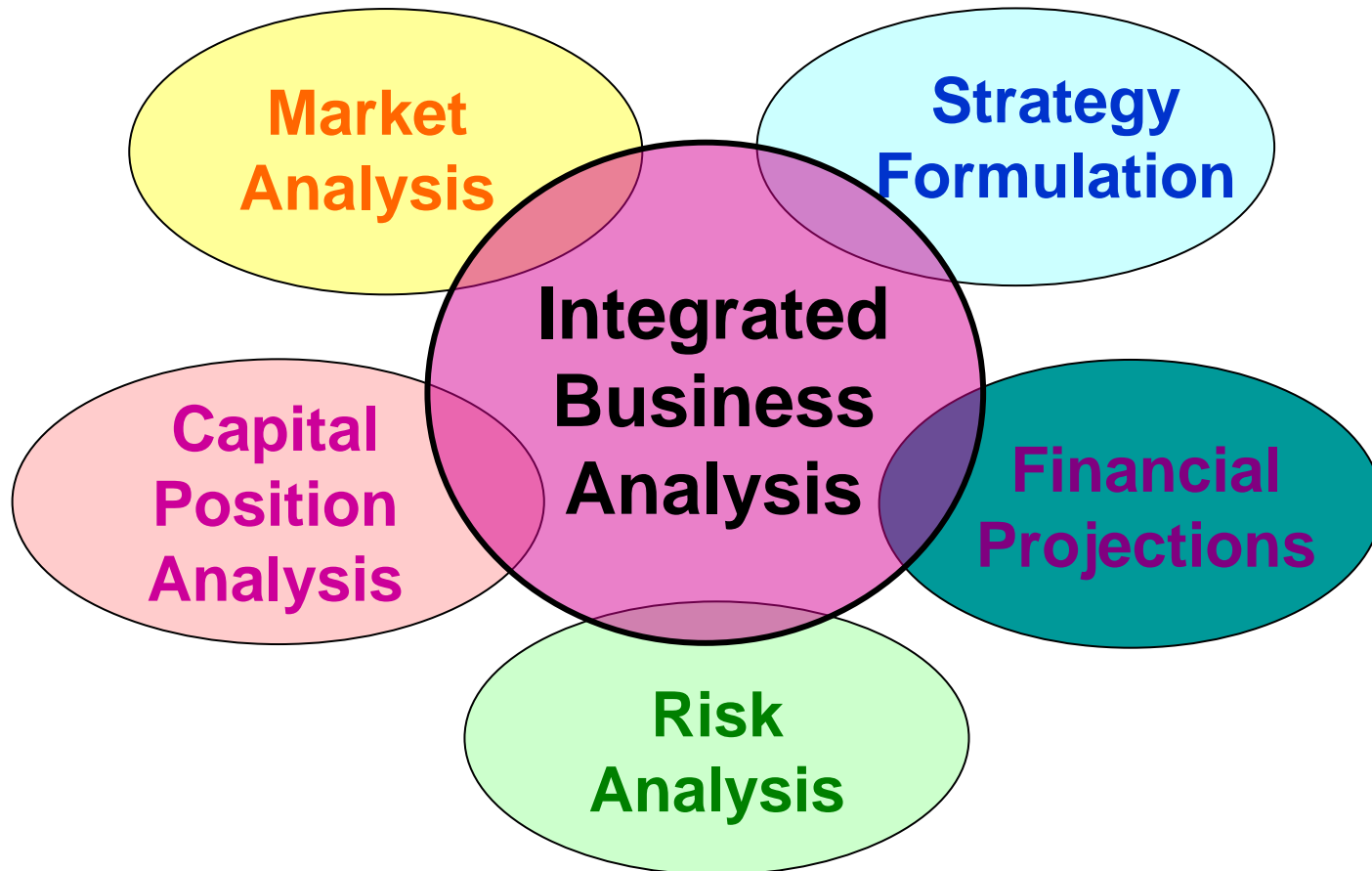
- Consistent application of standard analytic procedures is a key to successful evaluation and allocation of capital
- The “tried and true” techniques still provide the best basis for comprehensive decisions
  - Net present value (“NPV”) and risk-adjusted NPV
  - Internal rate of return
  - Multi-year cash flow projections
- More sophisticated techniques (e.g., Monte Carlo simulation) can further enhance the analysis
- Analytic requirements should be universal and well understood throughout the organization

## What Defines Good Analysis of a Proposed Capital-Based Initiative?

A presentation of the potential investment, including:

- Definition of the proposed initiative and the specific strategic objectives it will address
- Quantification of the capital resources required to initiate and complete the proposed investment
- Delineation of the potential market to be served and the means by which that market will be attracted to the investment
- Projection of the initial and ongoing operating requirements associated with the proposed investment
- Calculation of the potential return on investment, including analysis and quantification of key risks associated with the investment
- Identification of potential exit strategies and related performance measures

# Comprehensive Business Analysis Integrates Strategic and Financial Data to Generate a Complete, Risk-Adjusted View of Return on Investment



## Standardized Tools Are More Important than Ever

- Comprehensive analysis is best supported by standardized tools that will:
  - Define the projection structure
  - Incorporate globally applicable assumptions
  - Require delineation of all key initiative-specific assumptions
  - Include all quantitative and qualitative review criteria
  - Use weighted average cost of capital, discounted cash flow, and net present value techniques
- Given the risks and uncertainty of the new era, simulation and scenario testing capabilities are vital

**Doing both the right analysis and the analysis right are critical to best practice analysis**

# What Is the Right Analysis?

## The Basic Output Should Focus on Cash Flow

### B. Project Free Cash Flow Analysis

	2001	2002	2003	2004	2005	2006
Income from Operations	\$0	(\$51,811)	(\$178,923)	\$271,149	\$489,727	\$743,512
Add Back:						
Depreciation and Amortization	0	180,214	365,786	371,143	376,500	381,857
Less:						
Ongoing Capital Needs	0	0	75,000	0	75,000	0
Working Capital	0	36,815	12,656	62,570	35,169	40,778
<b>Net Free Cash Flow</b>	<b>\$0</b>	<b>\$91,589</b>	<b>\$99,207</b>	<b>\$579,722</b>	<b>\$756,057</b>	<b>\$1,084,591</b>

# What Is the Right Analysis?

## The Basic Output Should Focus on Cash Flow

### C. Net Present Value Computation

<u>Year</u>	<u>Initial Capital Investment</u>	<u>Project Cash Flows</u>	<u>Total Cash Flows</u>	<u>Terminal Value</u>	<u>Discounted Cash Flow</u>	<u>Cumulative Discounted Cash Flow</u>
2000	\$0	\$0	\$0		\$0	\$0
2001	(2,025,000)	0	(2,025,000)		(2,025,000)	(2,025,000)
2002	(750,000)	91,589	(658,411)		(597,096)	(2,622,096)
2003	0	99,207	99,207		70,803	(2,551,294)
2004	0	579,722	579,722		369,743	(2,181,551)
2005	0	756,057	756,057		430,927	(1,750,623)
2006	0	1,084,591	1,084,591		552,441	(1,198,183)
Terminal Year				3,919,414	1,784,064	585,882
Total	<u>(\$2,775,000)</u>	<u>\$2,611,166</u>	<u>(\$163,834)</u>	<u>\$3,919,414</u>	<u>\$585,882</u>	

Perpetuity Cash Flow Change

0.0%

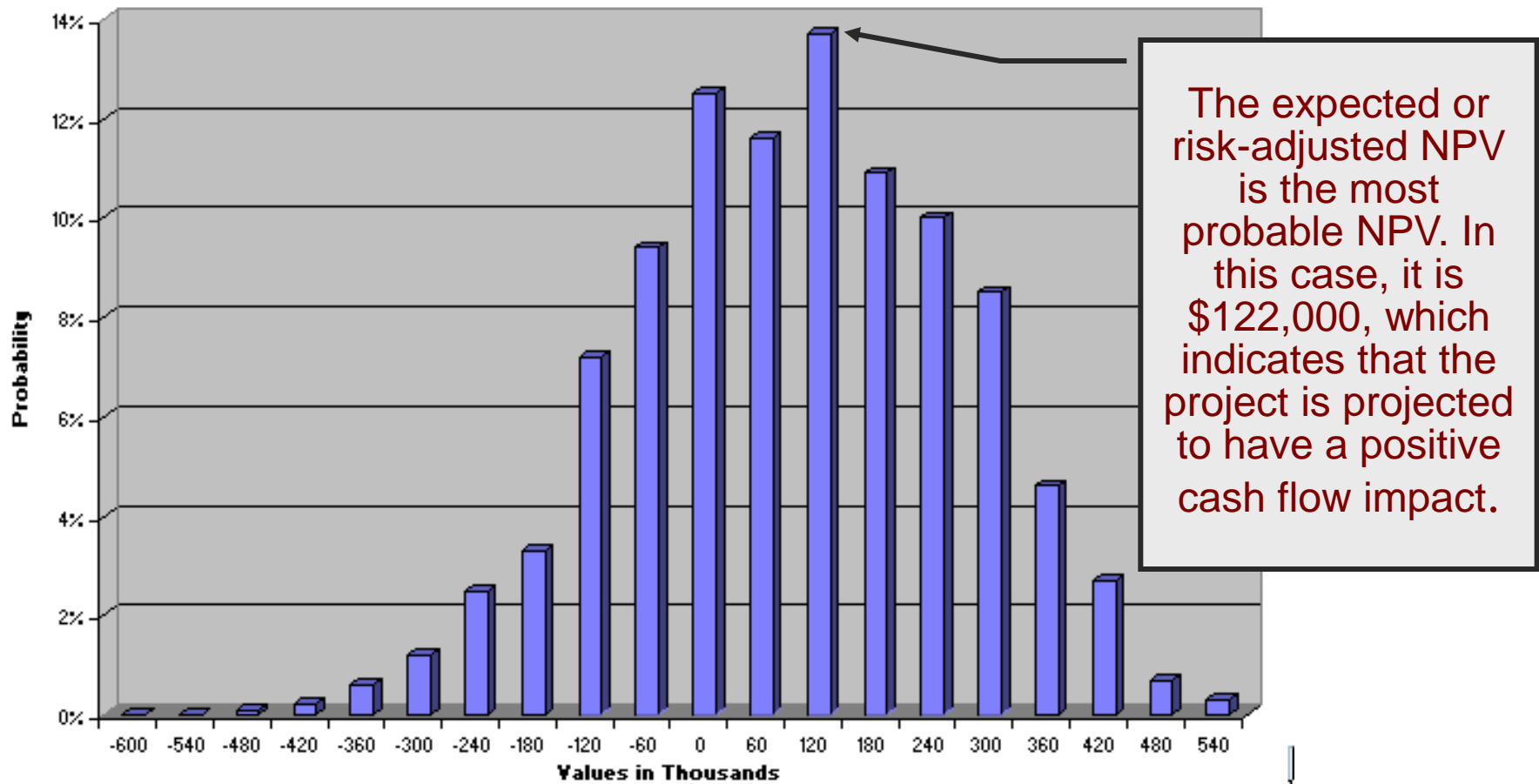
Total Project Life (in years)

10 years

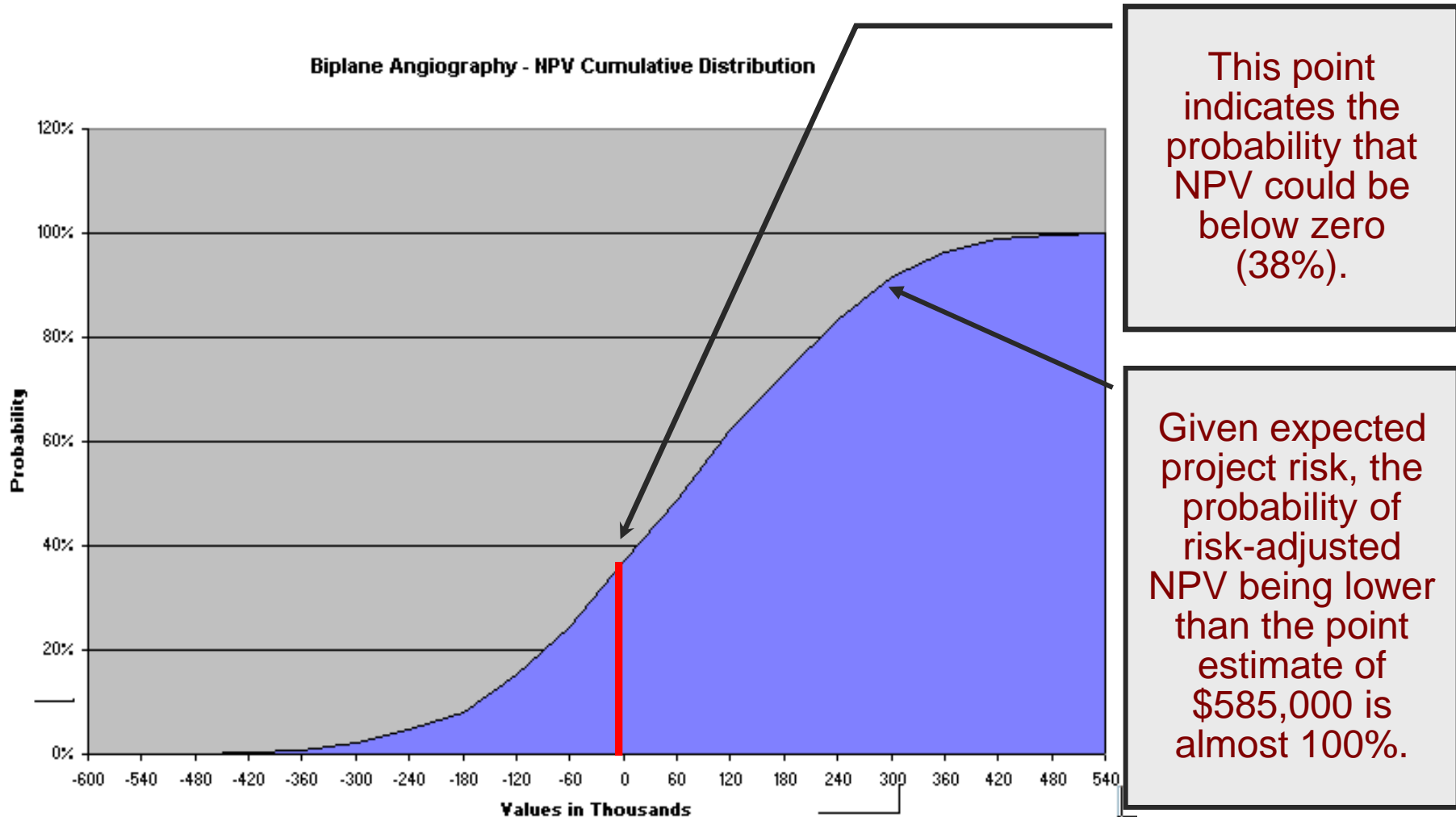
**NET PRESENT VALUE OF NET FREE CASH FLOW @ 11.9%**
**\$585,882**

## Moving Up the Analytical Curve – Simulating Risk

**Biplane Angiography - Net Present Value Distribution**



## Moving Up the Analytical Curve – Simulating Risk



## Why Is This Level of Analysis Important?

- An organization's long-term success depends on capital investment decisions made today
- Given the uncertainty in today's environment due to general conditions and the potential impacts of healthcare reform, "gut feel" is not enough
- Impending payment level and structure changes suggest a diminishing ability of hospitals' core business to support strategic capital investments

**The cost of making bad capital investment decisions is severe; real business analysis a framework for corporate finance-based decision making**

# Summary and Conclusions

## Effective Capital Allocation Incorporates 6 Critical Components

- Experience shows that the key to an effective capital decision-making process relates to just a few vital characteristics
  - ✓ Articulated objectives and principles
  - ✓ Broad definition of capital
  - ✓ Rigorous, standardized methodologies
  - ✓ Transparent governance and accountability
  - ✓ Known requirements and timing
  - ✓ Comprehensive implementation

## Ongoing Success in Ensuring Capital Availability Requires an Holistic Process

- Successful implementation requires thoughtful integration of capital allocation decision making with the organization's other key management processes
  - Strategic planning
  - Financial planning
  - Operational budgeting
  - Capital management

## An Integrated, Comprehensive Decision-Making Process is Key



# Questions and discussion

## Biography and Contact Information

**Jason H. Sussman**, a Managing Director of Kaufman Hall, directs the firm's financial planning and capital allocation practices, and provides planning and financial advisory services for hospitals, healthcare systems, and physician groups. His areas of expertise include strategic financial planning, capital allocation, mergers and acquisitions, and various financing transactions.

Mr. Sussman is the author of *The Healthcare Executive's Guide to Allocating Capital*, which was published in 2007 by Health Administration Press, the publishing arm of the American College of Healthcare Executives (ACHE). In addition, he has authored articles for various industry periodicals, including *hfm* magazine, *Strategic Financial Planning*, and others, and was a contributing author to *Best Practice Financial Management: Six Key Concepts for Healthcare Leaders, Third Edition* and *The Financially Competitive Healthcare Organization*. Mr. Sussman received a Helen Yerger/L.Van Seawell Best Article Award from the Healthcare Financial Management Association (HFMA) for "Ensuring Affordability of Your Hospital's Strategies." He co-authored this article, which appeared in the May 2009 issue of *hfm* magazine.

Mr. Sussman has presented programs at national and regional seminars sponsored by the HFMA and its chapters, ACHE, the American Hospital Association, numerous state hospital associations, and the National Association of Children's Hospitals and Related Institutions.

Mr. Sussman received an M.B.A. in Finance and Accounting with a specialization in Healthcare Management from Northwestern University's J.L. Kellogg Graduate School of Management and a B.A. from the Johns Hopkins University. He holds a CPA certificate in Illinois, is a member of the First Illinois chapter of HFMA, and is board certified in healthcare management as an ACHE Fellow (FACHE).

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