10 Statistics to Analyze a Hospital's Performance

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Kaufman Hall helps organizations design and implement capital allocation processes which provide consistent and rigorous methodologies to guide the capital decision-making process.

Discussion Agenda

- Industry Trends and Implications for Hospital Performance
- *Discussion:* Assessing Hospital Financial Performance
- Appendix: Additional Information

Industry Trends and Implications for Hospital Performance

Setting the Context

National Healthcare Overview

- Volume declines, escalating operating costs and continued reimbursement challenges have put tremendous pressure on the industry even before health reform
- The industry is transitioning to a new model requiring a new set of core competencies for health systems; health reform is the accelerant
- Pursuit of economies of scope, scale and vertical integration remain important factors to solidify long-term viability especially at the regional level
- The hospital/ health system market remains extremely fragmented compared to other industries and the future outlook is for more consolidation; however, the nature of partnership in the provider industry has become more strategy driven with numerous examples of strong organizations partnering

What *Is Likely* to Occur with Healthcare Reform as a Result of the Changing Climate

- Near term: moderate to severe reductions in provider reimbursement
  - Across the board hits… a "ready, fire, aim" mentality given the need for rapid action?
  - Targeted cuts with consideration to key political constituents?
- State government will play a larger role in defining how reform policy advances are executed
- Near/ intermediate/ long term – the evolution of the reimbursement model will continue to advance from an activity-based to a value-based system driven by both private and public initiatives; forward-thinking providers are not waiting for this to happen to them, but are instead advancing the movement through their own internal and external initiatives

Implications for Providers

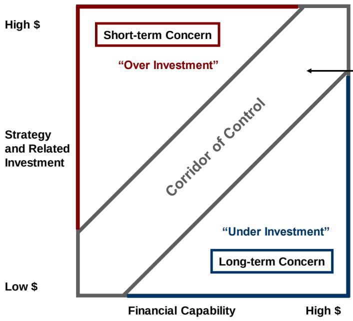
- Near-term success will be dependent on the ability to impact and manage organizational *cost structure*
- Longer-term success will be dependent on the ability to deliver *value* (measurable and demonstrated quality/ cost)
- A new set of *core competencies* will be required to achieve both of the above
- At its core, we are faced with a *production problem*
- *Provider industry aggregation* seems inevitable given this set of core competencies and this production problem
- *Standing still is not a viable option*

A New Set of Core Competencies Will Be Required for Success in the Future

Core Competency Areas	Key Characteristics of the Best Prepared
Physician/ Hospital Integration	A highly aligned medical staff characterized by shared goals, outcomes-based contractual arrangements, significant planning input, and adequately represented in organizational governance
Care Coordination/ Management Capability	Use of care coordination tools and processes by an empowered and integrated workforce to meet performance goals that are regularly measured and reported
Information Systems Sophistication	An IT platform that supports clinical decision making, information management, facile communications, and access by all stakeholders (physicians, patients, administration) to proper treatment and strategic decision making
Service Distribution System Effectiveness	A rational service distribution system that has accessible primary care and easy access (both physically and through referrals) across the care continuum, delivered in contemporary facilities with contemporary equipment
Cost Management	A right-sized organization-wide cost structure, highlighted by appropriate levels of staffing, capital spending, overhead support, and supply chain costs; constantly reviewed based on comparative peer group studies and benchmarks
Scale and Market Essentiality	Sufficient scale to attract competitive clinical and administrative talent, realize economies, drive marketplace innovation, and be an essential provider to health plans and patients
Brand Identification	Well recognized and respected, associated with high-quality and service excellence.
Payor Relationships/ Contracts	Maintaining strong relationships with payors and the ability to negotiate support for "new era" business practices
Financial Strength/ Capital Capacity	Strong appeal to capital markets through sustained operations, revenue growth, and balance sheet strength

Discussion: Assessing Hospital Financial Performance

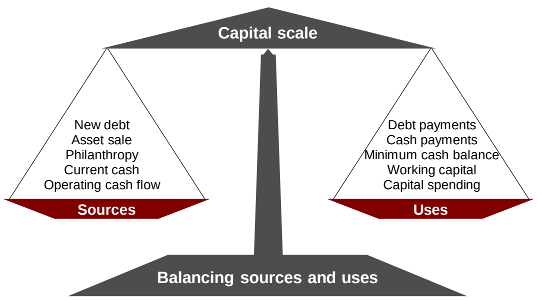
The Critical Relationship Between Strategy and Financial Capability



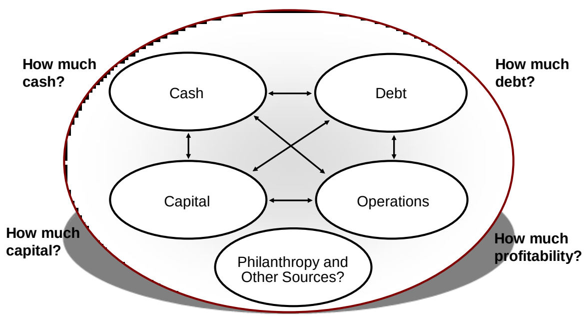
The corridor of control is the balancing point between two opposing goals:

1. Compete as effectively as you can, which requires aggressive investment of capital and commitment of operating dollars, BUT
2. Respect the fiduciary role of the Board and management to protect the long-term financial integrity of a community asset.

Striking a Long-Term Balance Between Sources and Uses of Capital



What Levers Do We Have to Work With?



How should these tradeoffs be optimized within an appropriate credit and risk context?

Example – Projected Performance Summary ($ millions)

Ratio/Statistic	Moody's "Aa3"	S&P "AA-"	Moody's A1	S&P A+	Projected Years 2011	2012	2013	2014	2015
Net Patient Service Revenue	$1201.8	$581.0	$690.3	$462.2	$506.4	$538.0	$587.2	$642.1	$691.4
Operating Income	$47.2	-----	$20.5	-----	$12.2	$18.7	$13.5	$12.6	$11.8
Net Income	$89.1	-----	$43.7	-----	$29.4	$33.5	$25.9	$22.2	$18.4
Operating EBIDA	$126.8	-----	$80.0	-----	$67.4	$74.0	$70.8	$72.3	$73.7
Cash Flow (Net Inc + Depr)	-----	-----	-----	-----	$73.4	$77.7	$72.0	$70.5	$68.9
Unrestricted Cash	$711.5	-----	$358.4	-----	$365.8	$391.7	$412.6	$432.6	$450.3
Total Debt	$447.0	-----	$295.5	-----	$283.3	$277.6	$271.9	$266.2	$260.5
Capital Expenditures	$110.3	-----	$64.9		$57.6	$50.0	$50.0	$50.0	$50.0
Profitability									
Operating Margin	3.4%	6.2%	3.3%	4.3%	2.3%	3.3%	2.2%	1.9%	1.6%
Operating EBIDA Margin	10.0%	-----	10.4%	-----	12.7%	13.1%	11.5%	10.8%	10.2%
Excess Margin	6.6%	2.7%	5.9%	3.2%	5.4%	5.8%	4.1%	3.3%	2.5%
Debt Position									
MADS Coverage (x)	5.6 x	6.2 x	5.1 x	3.9 x	5.0 x	5.3 x	4.9 x	4.8 x	4.7 x
Debt to Capitalization	33.9%	27.9%	37.6%	32.6%	36.2%	34.3%	32.7%	31.4%	30.3%
Liquidity									
Cash to Debt	154.8%	181.4%	129.5%	158.5%	129.1%	141.1%	151.7%	162.5%	172.8%
Days Cash On Hand (days)	201.5	250.7	182.3	212.0	281.0	284.0	270.7	258.5	249.5
Other									
Days in A/R, net	46.6	45.0	46.1	46.1	42.1	46.8	46.8	46.8	46.8
Average Age of Plant	9.0	9.5	9.2	8.8	7.1	7.7	7.9	8.1	8.4
Capital Spending Ratio	160.0%	154.3%	130.0%	131.5%	130.9%	113.3%	108.5%	103.5%	99.0%
Compensation Ratio (% NPSR)	-----	48.2%	-----	52.0%	52.7%	52.0%	52.8%	53.1%	53.5%

Note: S&P and Moody's medians based on most recently available not-for-profit healthcare rating reports

Definitions of Key Financial Ratios

Operating Margin:
Operating Income / Total Operating Revenue

Excess Margin:
Excess of Revenues Over Expenses / Total Operating and Non-operating Revenue

Operating EBIDA Margin:
Operating Income + Depreciation, Amortization and Interest / Total Operating Revenue

Compensation Ratio:
Salaries, Wages and Benefits, Contract Labor / Net Patient Revenue

Days Cash on Hand:
Cash and Marketable Securities + Board Desig. Funds / ((Total Operating Expense - Depreciation) / 365)

Debt to Capitalization:
Long-term Debt / Long-term Debt + Unrestricted Net Assets

Cash to Debt:
Unrestricted Cash / Long-term Debt + Short-term Debt

Days in Accounts Receivable:
Accounts Receivable x 365 / Net Patient Revenue

MADS Coverage:
Net Income + Depreciation + Interest Expense / Maximum Annual Debt Service

Average Age of Plant:
Accumulated Depreciation / Annual Depreciation Expense

Capital Spending Ratio:
Additions to Plant, Property and Equipment / Depreciation Expense

Capital Spending to Revenue:
Annual Capital Spending / Total Operating Revenue

Financial Ratio Explanations

Operating Profitability

- **Operating margin** – reflects the profitability of an organization from its active patient care and related operations
- **Operating EBIDA margin** – provides a good look at an organization's ability to generate enough cash to meet interest and principal payments on debt
- **Excess margin** – reflects profitability from operations and includes revenue and expenses from non-operating activities such as investment earnings and philanthropy

Debt Indicators

- **Debt service coverage ratio** – measures the ability of an organization's cash flow to meet its debt-service requirements
- **Debt to capitalization ratio** – indicates how highly leveraged, or debt financed, the organization is – the higher the capitalization ratio, the higher the risk

Liquidity Indicators

- **Days cash on hand** – probably the most important credit ratio in use today, reflects the number of days cash set aside by the organization to support operating expenses if revenue stream were to be reduced or eliminated
- **Cash to debt ratio** – measures the availability of an organization's liquidity to pay off existing debt

Other Ratios

- **Capital spending ratio** – a relatively new metric, assesses capital spending as a percentage of depreciation
- **Compensation ratio** – measure how much personnel expenses are required to generate one dollar of revenues

Discussion / Questions / Comments?

Thank You!

Appendix: Financial Statements

The Three Key Financial Statements

	Income Statement	Balance Sheet	Statement of Cash Flow
What Does it Tell Us?	Revenue - Expenses = Profitability	Snapshot of: • What we have • What we own • What we owe	Detailed accounting of cash in/ outflows
Things You *Might/Might Not* Already Know	• Also called P&L • Most intuitive of the statements • Only illustrates performance over a defined period of time • Not all items shown reflect cash in/ outflow	• Where you find info on cash balances, debt • Statement that tells us the most about an organization's financial health • Snapshot of a point in time	• Divides cash flows into 3 groupings: Operating, Investing, and Financing • Provides context for Income Stmt and Bal Sheet
Analogy to Personal Finance	Paycheck - Monthly Exp = Savings	Home mortgage, equity, car&loan, checking, stocks retirement acct	Checkbook register

A Closer Look at the P&L (Income Statement)

Net Patient Revenue
+ Other Operating Revenue
= Total Operating Revenue

Salaries, Wages and Benefits
+ NonSalary Cash Op. Expenses
+ Depreciation
+ Interest
Total Operating Expenses

Total Operating Revenues
- Total Operating Expenses
= Income from Operations

+ Non Operating Income

Net Income

- What does this tell us?
  - Revenue generated from Ops.
  - Cash operating expenses (salaries, supplies, etc.)
  - Accounting profitability
- What DOESN'T this tell us?
  - Capital spending
  - Debt service
    - ✓ Notice: includes interest but not principal payments
  - New borrowing
  - Cash generated from Ops.
    - ✓ Depreciation is a non-cash item… but WHAT DOES THIS MEAN?

A Few Things About the Balance Sheet…

Assets	-	Liabilities	=	Net Assets
• Cash • Receivables • Inventory • Property • L.T. Assets		• Debt • Payables • L.T. Liabilities		• What We Own
Cash & Capital Spending		Debt & Borrowing		

Key Questions

How much cash does an organization need?

How much debt can it afford?