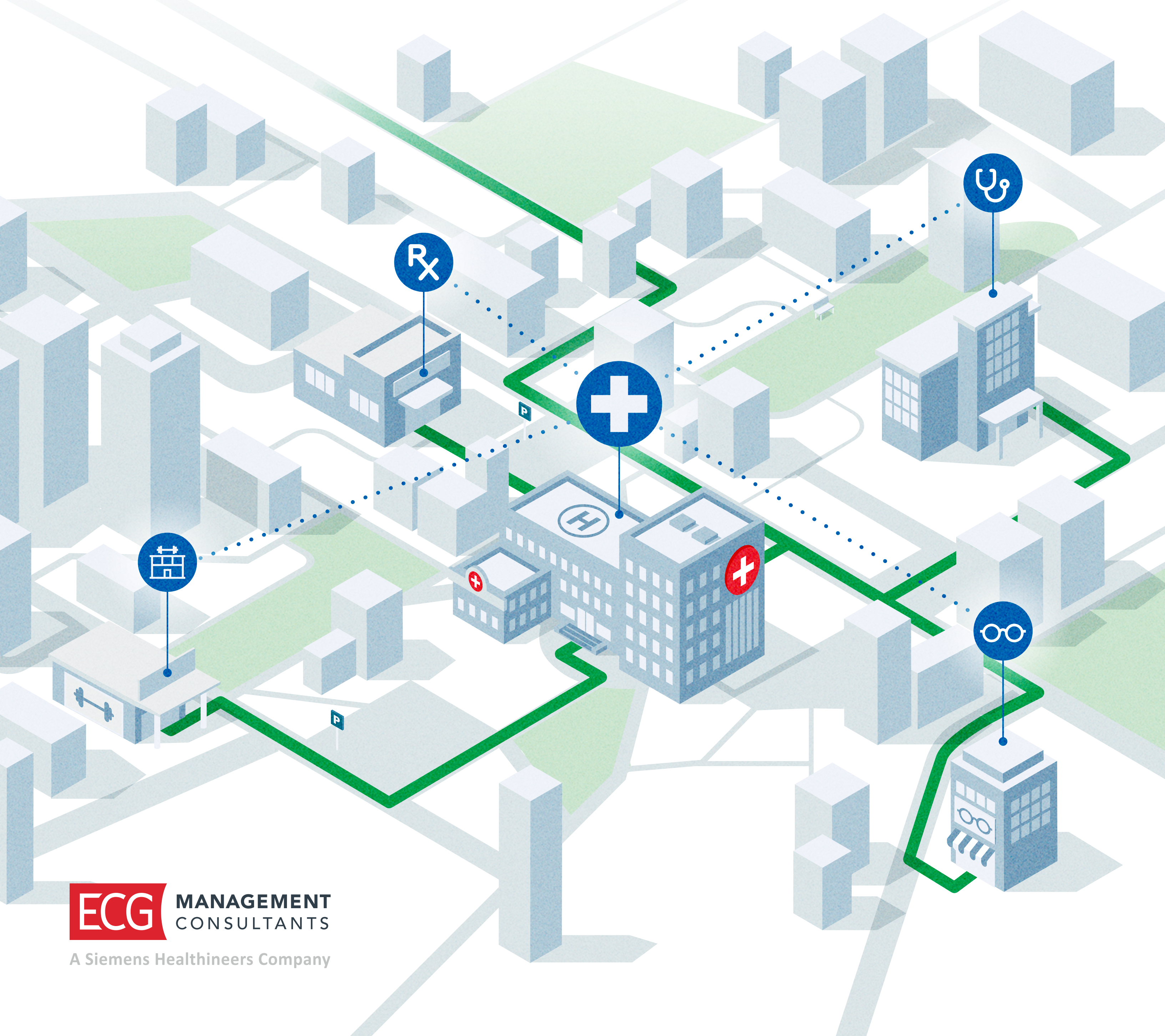
Health System Scale Is Irrelevant Without Performance

ECG's WeBELIEVE SERIES

Part 3



ECG MANAGEMENT CONSULTANTS

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Introduction

Health systems are aggregating into regional, superregional, and national health systems, predicated on a strategy of gaining economies of scale, standardizing and improving care, and building balance sheet strength. However, in few instances have these systems elevated the performance of their individual hospitals or returned the benefits of scale to consumers in terms of lower costs.[1]

Over the past 20 years, the benefits of scale have often been achieved within single facilities, but only occasionally have they been achieved by regional health systems and rarely by multiregional and national systems. Several studies[2,3,4,5,6] have shown that healthcare provider consolidation often weakens performance rather than enhancing it. That is changing rapidly, and the benefits from continued consolidation to all stakeholders—patients, communities, employers, payers—are now starting to be realized.

So, what's changed? Data and the tools to understand the data. Never before have we had so much data, and never before have we been able to put it to use like we can today. Without scale, a health system can't collect enough data, can't adequately invest in the technology infrastructure and analytical capabilities needed to use it, and can't apply the findings across a large enough population to make the required investment worthwhile. Quite simply, without adequate scale, healthcare provider organizations will find it difficult to be relevant while those with scale apply insights derived from big data to improve quality, reduce costs, and manage the risk of caring for a population.

We believe health systems must scale to achieve a level of market indispensability characterized by an integrated provider network able to invest in data analytics, bear risk, and offer patient-friendly physical and virtual care settings. But scale doesn't guarantee relevance. Bigger doesn't result in better. Only those health systems that grow while advancing performance through the investment in and application of data analytics to inform clinical, strategic, operational, and financial decisions will prove relevant and achieve the vision they have established for themselves.

This paper is the third in a series of five ECG strategic perspectives on the changing dynamics of the US healthcare system.

Why Is Scale Important?

Larger health systems, on average, provide better care at lower costs than smaller health systems. And the gap will grow.

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The largest 50 metropolitan statistical areas (MSAs) in the United States account for approximately half of the nation's population. In studying these MSAs, on average, the largest three health systems in each MSA substantially exceed the median performance of all health systems in the MSA. As illustrated in figure 1, the financial performance, as measured by operating margin, and quality performance, as measured by CMS Star Ratings, of the largest health systems consistently surpass overall market performance.

LARGEST THREE HEALTH SYSTEMS' MEDIAN PERFORMANCE VERSUS MSA MEDIAN PERFORMANCE (TOP 50 MSAS)

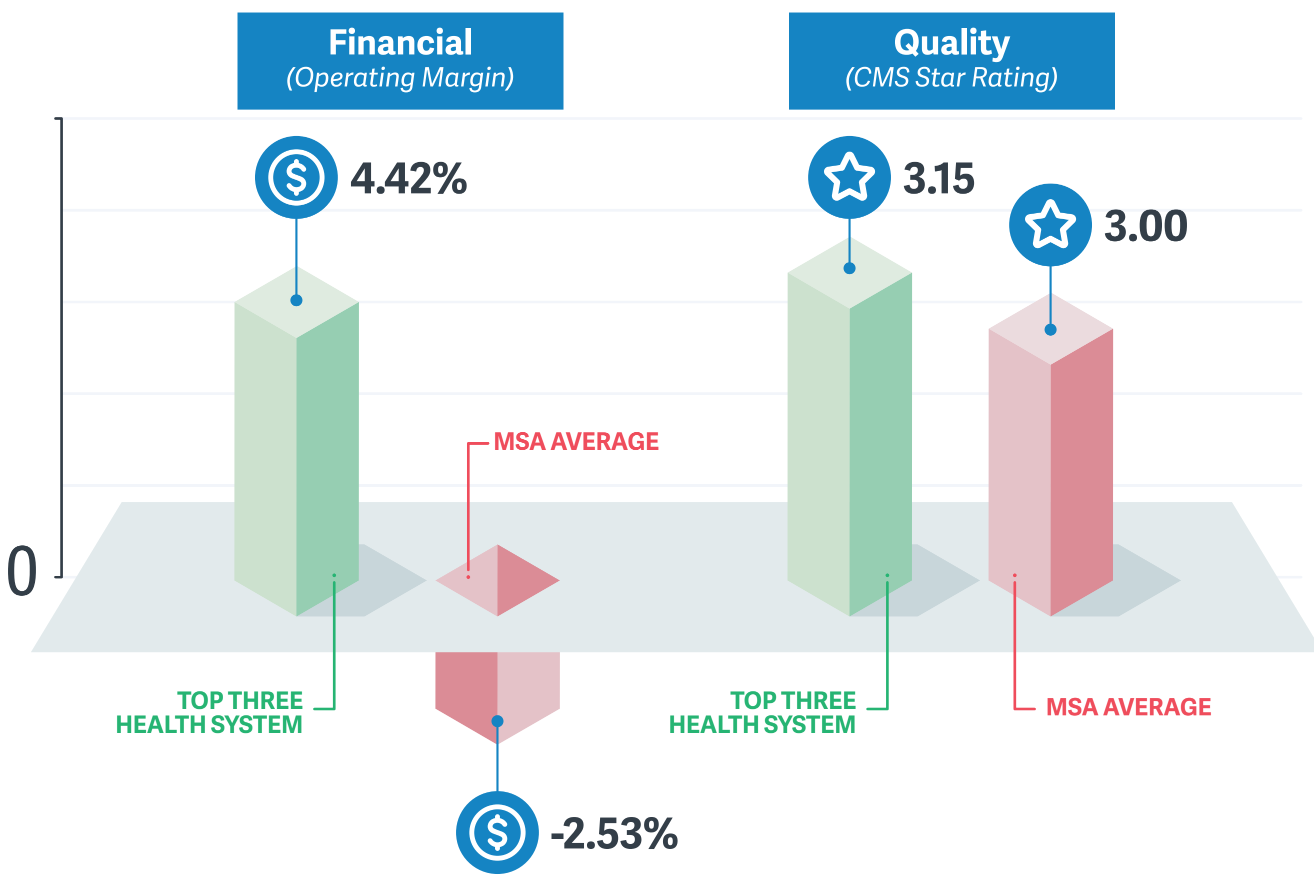


Figure 1: Largest Three Health Systems' Median Performance versus MSA Median Performance (top 50 MSAs)

Better performance is not only associated with health system size—there is also a correlation between market leaders' performance and the market concentration where those systems operate. As shown in figure 2, the median operating margin of the top three health systems in highly concentrated MSAs is over 7%, compared to a median operating margin of less than 0% across all market participants in MSAs of moderate and low concentration. Based on these results, one could infer—and they would be correct—that performance is optimized by large health systems in highly concentrated markets. Furthermore, the highest-performing health systems in the best-performing MSAs typically have a combined market share of greater than 80%; this is the case in 17 of the 20 highly concentrated MSAs.

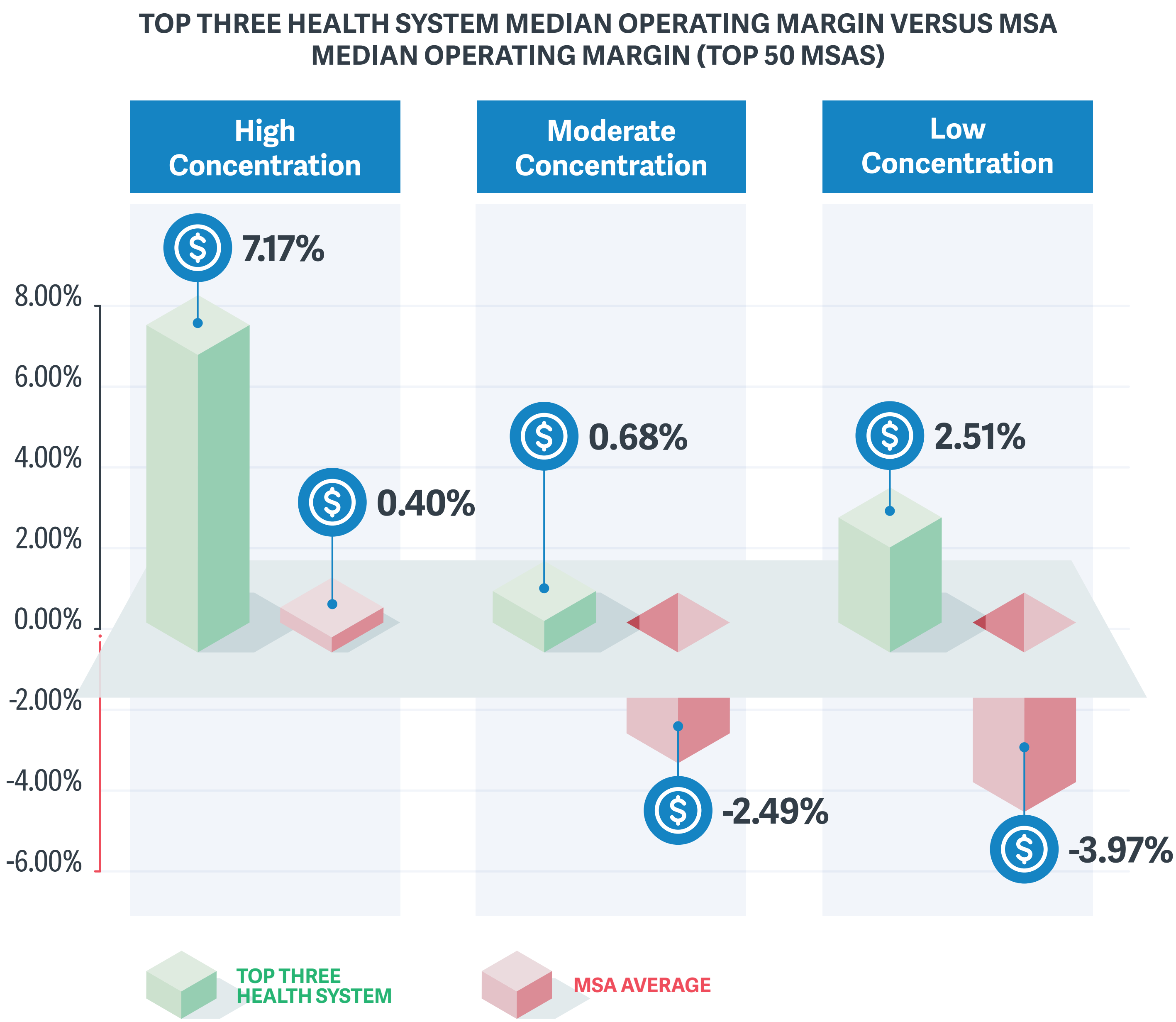


Figure 2: Top Three Health System Median Operating Margin versus MSA Median Operating Margin (top 50 MSAs)

However, not all health systems in highly concentrated markets obtain higher financial and quality measures than those in less-concentrated markets. Of the top 50 MSAs across the United States, 20 of them (40%) are considered to have a high market concentration of healthcare providers, 21 (42%) have a moderate concentration of providers, and 9 (18%) have a low for concentration of providers.[7,8] As seen in figure 3, the median operating margin and median CMS Star Rating for all systems within an MSA does not correlate with market concentration.

MSA MEDIAN OPERATING MARGIN AND WEIGHTED CMS STAR RATING PERFORMANCE (TOP 50 MSAS)

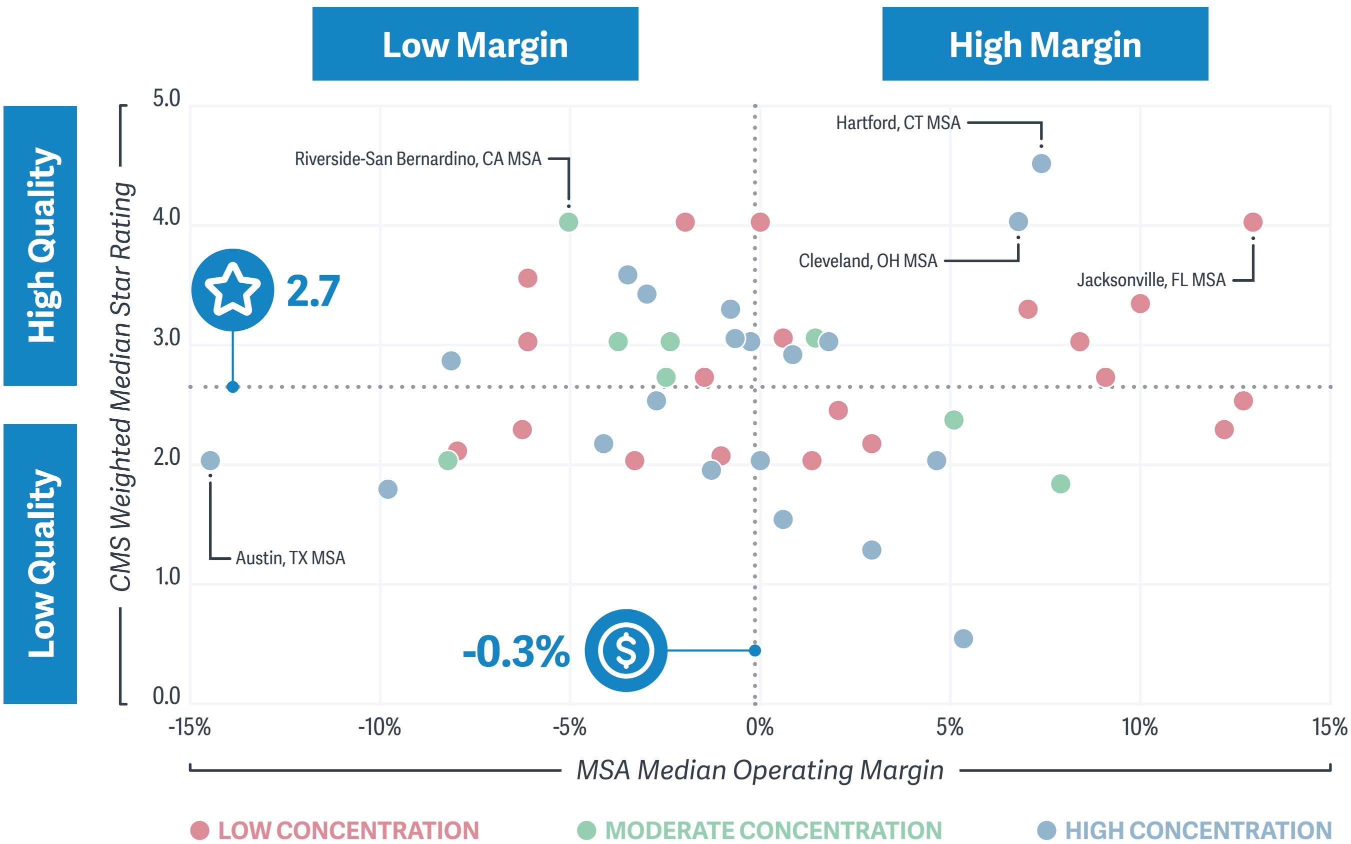


Figure 3: MSA Median Operating Margin and Weighted CMS Star Rating Performance (top 50 MSAs)

Figures 2 and 3 provide two insights:

- Regional market dynamics play a large role in financial and quality performance for all systems operating in a market.
- Large disparities in performance exist between the top three systems and the rest of the systems within highly concentrated markets.

As concentration increases over time, the delineation between market leaders and laggards is accentuated. These findings are not surprising. In fact, they're common in most industries—especially more mature ones.

The Rule of Three

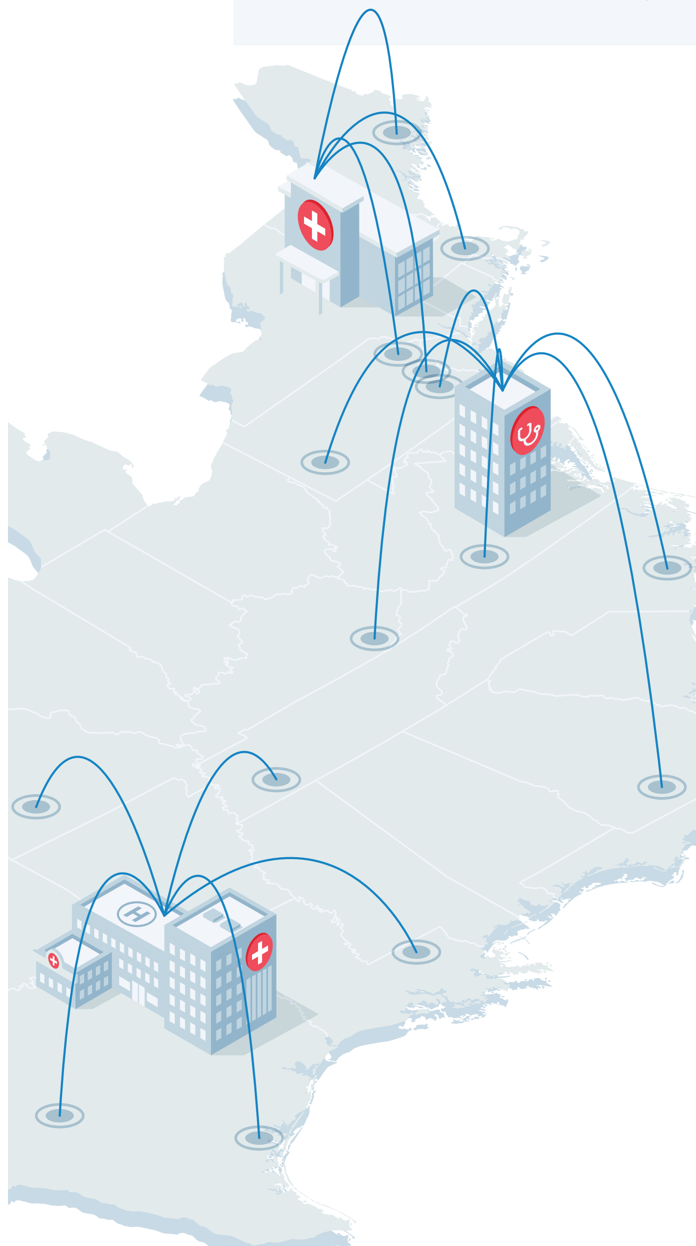
With few exceptions, firms in all industries benefit from scale, and so do their customers. The "Rule of Three" has been analyzed, debated, and applied in various ways since 1976 when Bruce Henderson of the Boston Consulting Group first presented his hypothesis "The Rule of Three and Four." In 2010, Can Uslay, Ayca Altintig, and Robert Windsor published an empirical study of the Rule of Three based on Sheth and Sisodia's 2002 book, The Rule of Three: Surviving and Thriving in Competitive Markets. Among their findings were that:[9]

- Three "generalist" firms tend to control the market in mature industries.
- Markets that conform to this structure typically outperform markets with more or fewer generalists.
- The large generalists outperform smaller generalist firms (which are considered "in the ditch").
- Specialists are able to compete, provided they remain disciplined and focused on their niche.

Although the Rule of Three is intended to cover an entire industry, our analysis shows it also applies to healthcare on a regional basis. In short:

- Markets that have not already consolidated will do so such that three health systems will account for 80% of the market.
- The three largest health systems will perform better than smaller generalist health systems.
- Specialists (e.g., single-specialty hospitals, critical access hospitals) may maintain high performance, provided they remain focused on their core competency.

We should expect the growth of national and multiregional health systems to not only continue but intensify.



Furthermore, we should expect the growth of national and multiregional health systems to not only continue but intensify. The additional financial pressure placed on independent hospitals and small regional systems by COVID-19 is driving many of them to seek the enhanced security of a larger system. Figure 4 illustrates the movement of independent hospitals into systems since 2005.

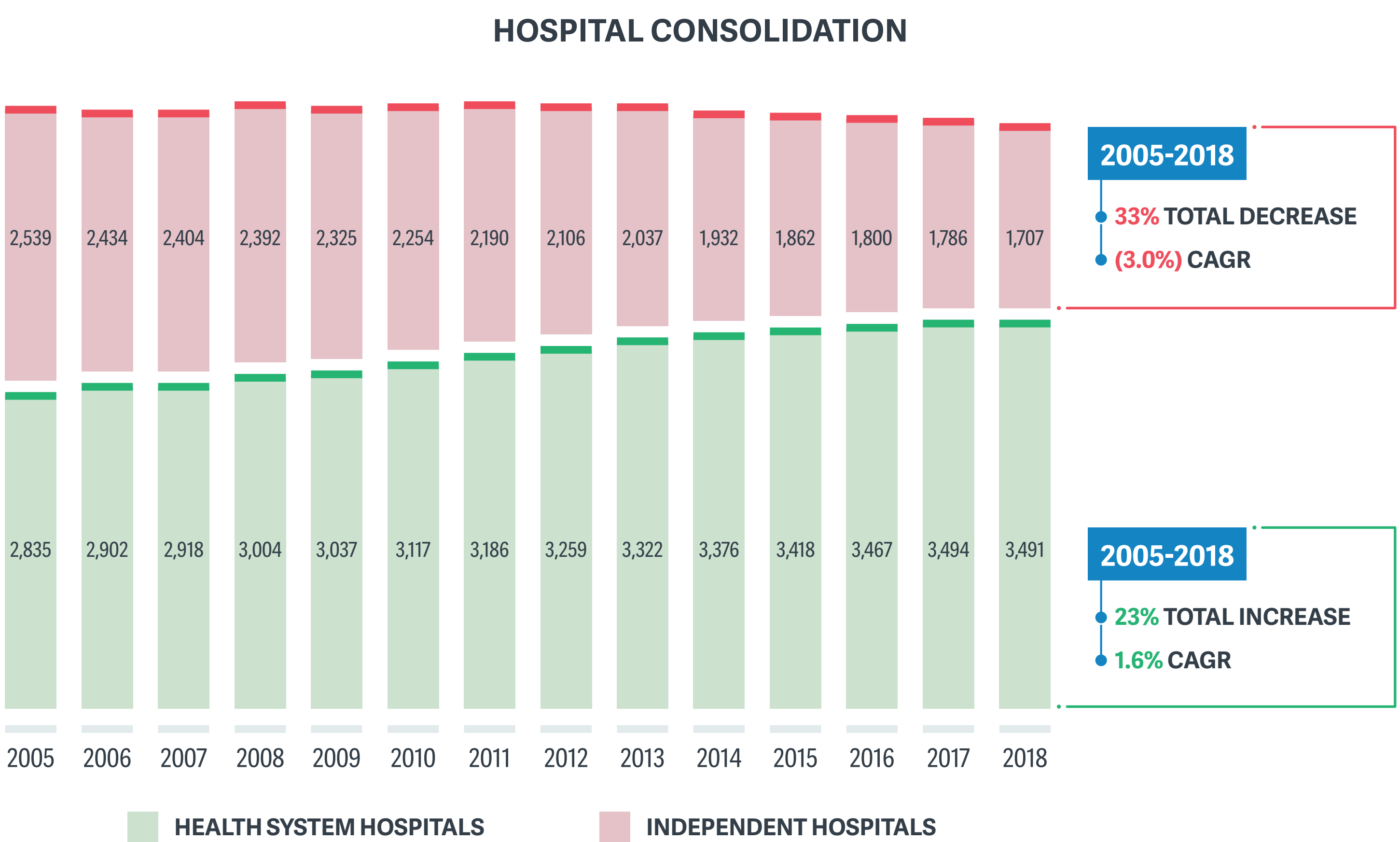


Figure 4: Hospital Consolidation
Source: 2005–2018 data, AHA TrendWatch Chartbook 2019.

So, what does this mean for your health system? A priority for many health systems will be to do what is necessary to avoid, or get out of, "the ditch"—the space in which generalists that are not top-three systems find themselves, with small market share and poor performance. Strategic decisions will depend on your health system's position within your own market. However, based on these industry trends, there are several general strategies to consider, depending on the degree to which your market has already consolidated and on your system's relative size:

1. Small systems in unconsolidated markets should specialize, merge with similarly sized systems, and/or seek to be acquired by a system capable of establishing and maintaining scale.

2. Small systems operating in consolidated markets should specialize or seek to be acquired by a system capable of establishing and maintaining scale.

3. Large systems in unconsolidated MSAs should consider merging with similarly sized systems and/or pursuing multiple acquisitions of smaller systems to secure a place as one of the largest three systems in the regional service area.

4. Large systems operating in consolidated MSAs should selectively acquire and affiliate with smaller systems to avoid losing their position as one of the largest three systems.

5. Large systems should pursue mergers across regional markets to begin to establish a national presence.

Scaling Vertically to Advance Health—and Wellness

OK. So you need to be part of a big health system, and big health systems need to get bigger so they can put big data to big uses. Yes, size does matter. So does breadth. Many of the most useful applications of the data health systems are gathering require a comprehensive network of care. And the more comprehensive the network, the more robust the data. This data will provide longitudinal information that will empower health systems to not only understand their patients when they are sick but offer insight into the general well-being of the populations they serve. Vertical integration offers that ability.

The migration to outpatient services will continue, and health systems must continue to invest in providing services where consumers are seeking them. Figure 5 illustrates the migration from the inpatient setting to outpatient care over the past 10 years.

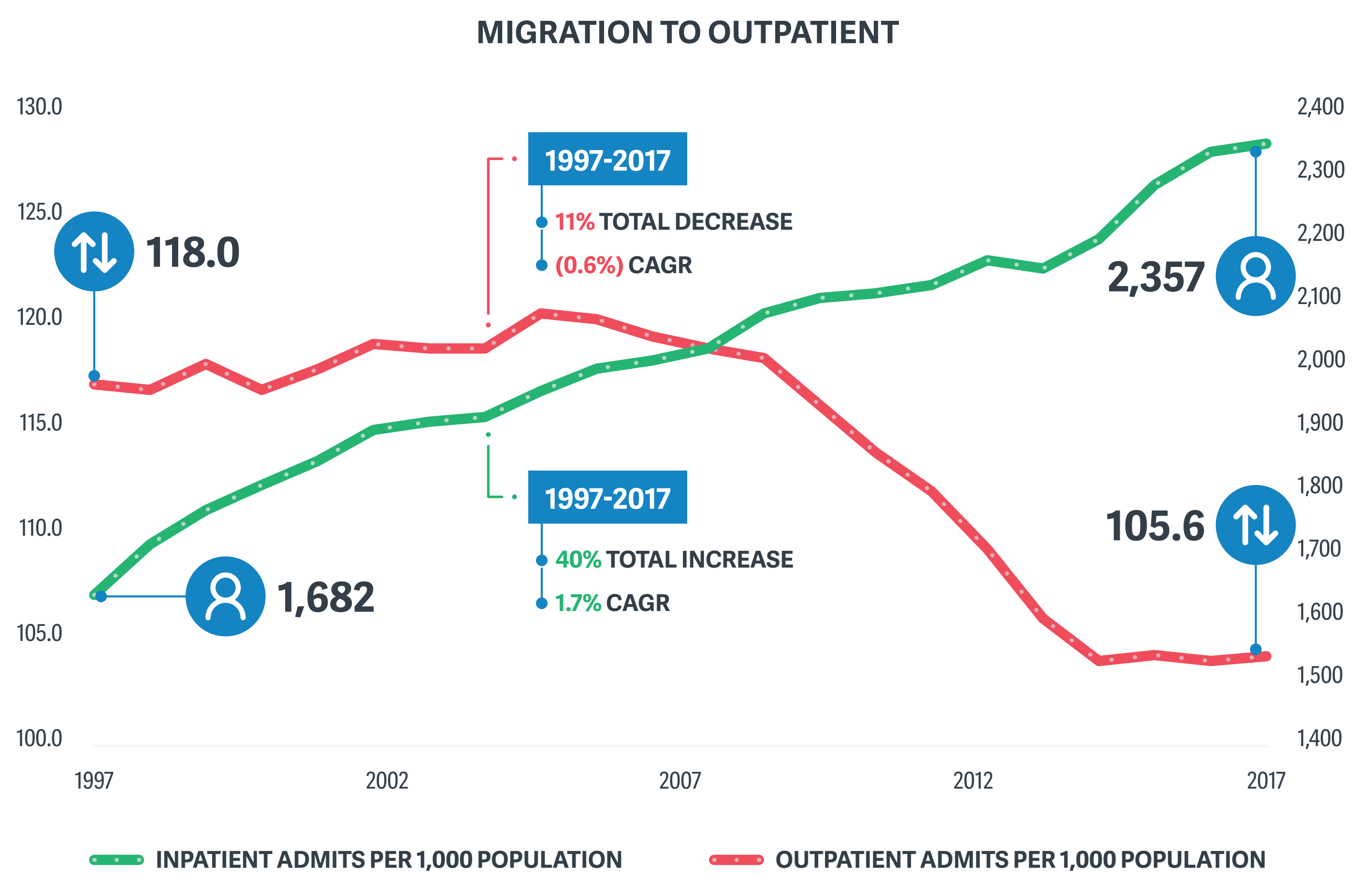


Figure 4: Hospital Consolidation
Source: AHA TrendWatch Chartbook 2019.[10]

Broadening a health system's perspective of vertical integration allows for management of an even greater portion of a community's health and well-being. Health systems with a patient-centric focus and a population-based care model will achieve a competitive advantage when applying data. A health system seeking to develop lifelong relationships with its customers must first make sure it is filling all its service gaps so patients don't need to look elsewhere for care. So, ensuring a comprehensive healthcare delivery system with superior customer satisfaction and convenient physical and digital touch points is task one. But why stop there?

Rather than limiting the health system to the traditional continuum of care and those services reimbursed by traditional payers, consider moving to a continuum of life where the health system's role is to partner with customers in achieving and maintaining "health actualization."[11]

New revenue sources with higher margin potential than the health system's core business become apparent when the health system considers itself part of the $14 billion workplace wellness industry, $30 billion health club industry, and $120 billion wellness real estate industry. This expansion of the scope of services—provided either directly or through affiliations—allows a health system to fortify its relationship with consumers and increase profitability.

Consider the following facts, and ask yourself if an expanded perspective of vertical integration would help your system increase touch points with consumers, enrich data sources, and advance your ability to improve the community's health:

- Approximately 20% of all Americans belong to at least one gym, and they visit a gym an average of 104 days per year.[12]
- Approximately 65% of adults and 85% of children see a dentist at least once per year.[13]
- When Medicaid beneficiaries move into affordable housing, their primary care visits increase 20%, and emergency room usage decreases 18%.[14]
- Of medical professionals surveyed, 100% said they have dealt with patients who have expressed concerns and anxiety about affordable housing.[15]
- All hospitals provide food services and employ dietitians, and 12% of Americans are malnourished.[16]

Most health systems are still stuck in the business of sick care. It is time—past time—to recognize that the provision of acute care services as a core business is a failing business strategy. Investing in big acute care facilities is too.

Rather than limiting the health system to the traditional continuum of care and those services reimbursed by traditional payers, consider moving to a continuum of life where the health system's role is to partner with customers in achieving and maintaining health actualization.

Investing in Asset-Light Services

Owning stuff isn't what it once was. Ten years ago, among the 10 largest publicly traded companies were names like PetroChina (number 1), Exxon Mobile (number 2), BHP mining company (number 6), Walmart (number 7), and GE (number 9). These companies hailed from asset-heavy industries such as energy, mining, manufacturing, and retail. As of May 16, 2020, none of the top nine largest publicly traded companies in the world come from an asset-heavy industry; it takes until number 10, Johnson & Johnson.

Today's highly valued firms are asset-light companies—firms in technology and finance. These firms generate revenue while owning relatively few fixed assets; that is, they have a high fixed-asset turnover ratio (revenue divided by net fixed assets). Among the companies with the highest fixed-asset turnover ratios are health insurers. Cigna and Humana have fixed-asset turnover ratios in the 30s. In contrast, the fixed-asset turnover ratio for many health systems barely exceeds 2.

Asset-heavy businesses have high fixed costs and require consolidation to build market scale and high degrees of efficiency to drive return on assets. In contrast, asset-light businesses have low fixed costs and derive their return on assets from broad, efficient distribution networks and high utilization. Health systems are burdened by big buildings filled with expensive equipment. Although those big buildings need to be maintained, health system investments should be focused away from bricks and mortar and toward the delivery of ambulatory care, virtual services, and other asset-light sectors that broaden their health and wellness care services.

The decision to build, buy, or partner with a health system's growth into asset-light revenue streams will depend on myriad factors, including:

- Long-term vision for the product/service.
- Internal capabilities and the ability to attract/recruit necessary talent.
- Availability and value of potential partners or acquisitions.
- Competitive environment and barriers to entry.
- Branding preferences.
- Capital needs.

Chief among a health system's considerations is the urgency with which it is seeking to enter the market and the degree to which it currently possesses many of the capabilities to build the business. Figure 6 provides a simple summary of when a health system may choose to build, buy, or partner its way into a business, or reconsider entering the business at all.

HEALTH SYSTEM CAPABILITY AND URGENCY MATRIX

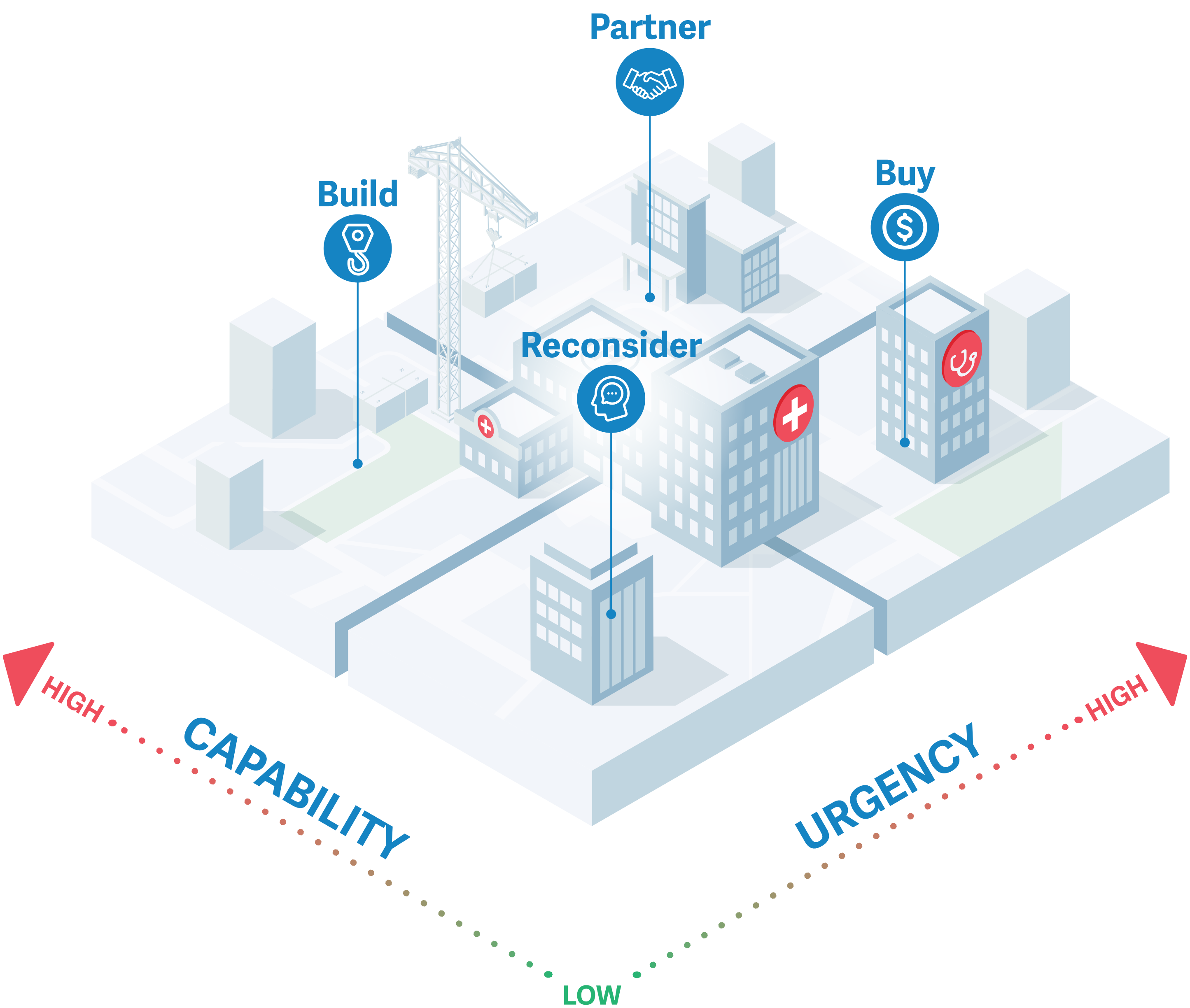
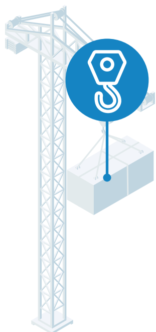
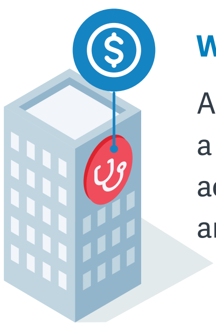


Figure 6: Health System Capability and Urgency Matrix



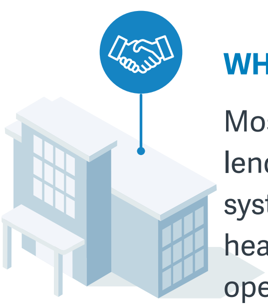
WHEN TO BUILD

Building will often be the preferred option when a health system already has many of the core elements of the new business. While this option is capital and time intensive, it allows an organization to define the scope and breadth of services, size of the edifice, and personalization of design to satisfy community and organizational goals.



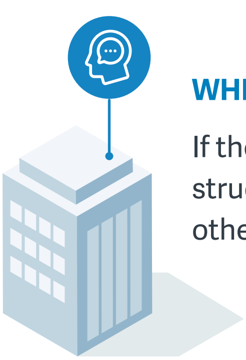
WHEN TO BUY

A fast way to both enter a new market and acquire the capabilities to perform well is to buy a business currently operating in the space. Barring the need for cultural alignment after acquisition, buying a business allows a health system to tap into rooted community relationships and network affiliations.



WHEN TO PARTNER

Most viable, profitable growth opportunities that fit within a health system's mission will lend themselves well to partnering. Fortunately, partnering is second nature for most health systems. Partnering can occur through joint ownership or contractual agreement. The typical health system has dozens (or hundreds) of management agreements, service agreements, joint operating agreements, and joint ventures. Partnering allows a health system to combine its strengths with organizations that possess dissimilar strengths, thus achieving additional scale without heavy investment of capital. Partnering, versus building or buying, frequently allows a health system to simultaneously lower its risk, accelerate its timeline, and reduce its cost.



WHEN TO RECONSIDER

If the health system doesn't possess many capabilities to perform well in a new business structure, and there is little urgency to move into the market, then it is likely time to focus on other priorities.

Achieving System Performance

Multiregional and national health systems are working to function more as operating companies and less as holding companies. The challenges are great, and, in many cases, leadership of these health systems should be commended for their progress. Consider the following five guiding principles when pursuing system performance:

1 DON'T LOOK FOR SCALE TO CREATE PERFORMANCE.

Achieve performance and then scale by integrating new organizations and new growth into your high-performing business. Health systems are currently experiencing record-low operating margins, despite years of operational improvements, layoffs, and consolidations. Worse, as we look ahead, health systems face a growing proportion of care reimbursed below the cost of providing it. Those that cannot enhance the value they provide through higher quality and lower costs aided by advanced analytics and artificial intelligence will fade away or be absorbed into those that can.

2 ENGAGE PHYSICIAN LEADERSHIP TO DRIVE SYSTEMWIDE REDUCTION IN CARE VARIATION.

Physicians throughout the system should be supported by centralized and regional personnel to enhance clinician-to-clinician collaboration; maximize use of clinical information systems; and design, develop, and implement solutions to reduce variation and spread innovation. The nation's best-performing hospitals are those with a high degree of physician leadership, where physicians have a strong voice in operations, and administration is seen as an enabler of the improvements physicians seek rather than a barrier. Physicians need to be empowered with timely cost, quality, and outcomes data that can support consensus building and guide decision-making.

3 OPTIMIZE CENTRALIZED SHARED SERVICES.

Standard, nonstrategic functions such as revenue cycle, patient contact centers, supply chain, finance, legal, HR, and IT should be managed at a system level. Although economies of scale through cost cutting are not a compelling reason to merge, the nuts and bolts of operating the health system must be optimized, and organizations added to the system must be effectively integrated.

4 ESTABLISH AN EFFECTIVE CONSOLIDATION STRATEGY.

Define the one core objective driving your consolidation strategy, and then measure every opportunity on its support of that objective. Below are four common strategies for value creation through consolidation in healthcare.

- Rationalization: Combining with a like company allows the consolidated organization to remove excess capacity from the market, eliminate redundancy, and achieve a more efficient use of assets. A market consolidator must be able to take organizations that will never achieve great performance on their own and fold them into one that can.
- Turnaround: Healthcare provider organizations often seek a partner only when they are about to fail. The integration plan for the acquired company must rely on more than simply enhanced payer contracts and cost reductions.
- Scaling Expertise: A danger of vertical integration is expanding into a sector in which system leadership may lack necessary expertise. However, the acquired company's management team may have the capabilities to not only continue to operate its existing business but also expand that business across the health system's broader footprint.
- Scaling Innovation: Corporate venture capital funds have become commonplace within major health systems. Many invest in emerging companies in key growth areas such as patient engagement, population health management, and digital health. They also frequently promote internal innovation that can be spun out into a new company. The health system can serve as an incubator, initial customer, and resource to understand how to refine products and offerings.

5 ALIGN CULTURE, STRATEGY, AND BRAND.

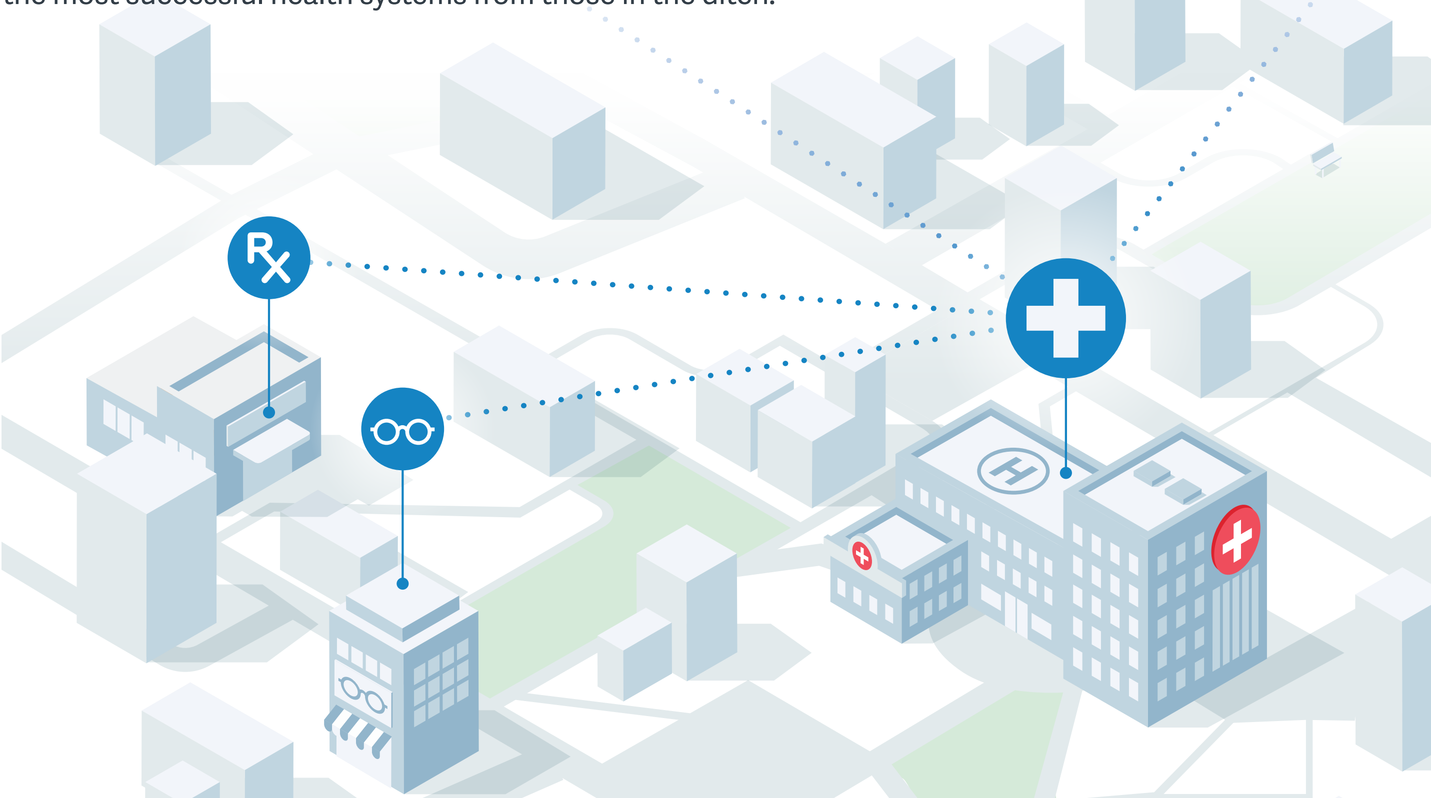
System performance is contingent on the system having a unifying culture—not one culture for the hospital, a second culture for the medical group, and separate cultures at different facilities or regions. And this singular culture must complement the system's branding. When culture, strategy, and brand are aligned, all stakeholders understand the health system's purpose, and that purpose guides all behaviors, decisions, and interactions. As a result, the experiences of patients, consumers, employees, physicians, donors, and volunteers are connected and consistent throughout the organization. Denise Lee Yohn states in FUSION: How Integrating Brand and Culture Powers the World's Greatest Companies, "You must cultivate a distinct culture that is fully aligned with your brand identity—that is so well integrated with it that it is hard to distinguish what you do internally from who you say you are externally."[17]

Becoming Essential

We believe health system scale is irrelevant without performance. The drive to achieve scale is not new for health systems or other participants in the healthcare sector. However, successful achievement of scale is not defined by number of beds, total size, or number of acquisitions—health systems must translate scale into performance, as measured by increased revenue, reduced costs, better health, and top quality and outcome measures.

Historically, the largest systems in highly consolidated markets have outperformed the market. Many of those high-performing health systems have successfully achieved scale over decades. However, consolidation will continue to accelerate due to a number of factors, including the availability of data and data analytics to inform decision-making, increasing financial pressures on smaller hospitals' ability to remain independent, and growing competition from nontraditional market entrants into financially attractive, asset-light, ambulatory, and ancillary services.

Health systems must achieve a level of market indispensability by creating an integrated provider network able to invest in data analytics, bear risk, and offer patient-friendly physical and virtual care settings. Traditional horizontal integration may still help reach a desired level of market indispensability. However, strategically pursuing vertical integration into asset-light delivery mechanisms, exploring new business/product expansion opportunities in the wellness industry, and ensuring a deliberate and structured approach to scale will separate the most successful health systems from those in the ditch.



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