Financial Services
Hospitals Feel the Squeeze From All Sides

The move to value-based care and the programs regulated by the Centers for Medicare & Medicaid Services (CMS) is compelling hospitals to consider ways to transform their operating models.

Steven Kennedy

Patrick Pilch

Hospitals are facing challenges in adapting their clinical, financial, and capital processes and structures to address both new modes of and clinical measurements for payments. Meanwhile, increasing pressures to consolidate, as evidenced in prominent examples of merger activity, are contributing to future complexity.

Where We Are Now

The dramatic impact healthcare reform has had on hospital payment has largely taken place within a shifting economic climate. Although they acknowledged in 2016 that investment-grade rated hospital balance sheets were strong, the three primary bond ratings agencies—Standard & Poor's, Moody's Investors Service, and Fitch Ratings—also began to caution that the sector is vulnerable to labor shortages and salary and wage pressures. This vulnerability could add to the stress healthcare organizations already have experienced due to lower payment rates and the shift from inpatient to outpatient care, which is leaving them with property and beds that are no longer producing income.

Moreover, there is concern that an increase in short-term interest rates is signaling that inflation may pick up and drive an increase in longer-term interest rates. This development would increase the cost of capital borrowing, says Steven Kennedy, senior managing director at Columbus, Ohio-based Lancaster Pollard, an investment banking firm that provides capital solutions to healthcare, senior living, and housing organizations.

"While higher interest rates would add expense pressure to all hospitals, stronger hospitals, which tend to have more robust liquidity positions, would be able to offset some of the added expense pressure through increased investment returns. Unfortunately, weaker hospitals without much cash or investments on the balance sheet do not have such a natural hedge against rising interest rates. Compounded with labor expense pressures, this situation could increase the divide between the haves and the have-nots," Kennedy says.

Where We're Going

Millions of Americans became insured under the Affordable Care Act (ACA); however, many hospitals are carrying a load of bad debt from patients with high-deductible health plans, says Patrick Pilch, head of BDO Consulting's healthcare advisory practice in New York. Although the continued move toward value-based payments is opening up areas of opportunity as well as areas of risk, a dismantling of the ACA and an increase in the uninsured population will exert pressure on hospitals.

Some organizations could offset the decrease in revenue with stronger earnings in investment portfolios, but many others—particularly small, rural hospitals—have capital locked up in physical infrastructure.

"From a capital perspective, not a lot of hospitals are designed to take on risk, especially associated with value-based payment," Pilch explains. "We already see the impact of assuming additional risk in not-for-profit hospitals that issue tax exempt bonds to raise capital for new labs or wings. The debt payment associated with that bond is based on fee for service."

Although the rate of mergers slowed at the end of 2016, hospitals continue to join forces, and large payers are consolidating. Patients also are stepping up as consumers to demand improved service, price transparency, and high-quality care. Those pressures, combined with the industry's continued shift in focus to outpatient care and the difficulty of recruiting and retaining top clinical talent, are increasing financial concerns for healthcare organizations. At the same time, these organizations are required to invest in compliance with the rules and regulations governing all aspects of health care, from patient privacy to outcomes of procedures.

Hospitals must respond to added risk that will come from Medicare Access and CHIP Reauthorization Act of 2015 (MACRA), which will drive consolidation and a move toward the vertical integration of delivery systems, and from programs designed to support better and more efficient care for Medicare patients. An example is the Comprehensive Care for Joint Replacement (CJR) Model, which requires hospitals and physicians to partner with post-acute care providers who will make sure that their patients avoid readmission.

The focus on improving the quality of care while containing cost will also affect site neutrality and technology.

Under site neutrality, payment is determined on the basis of the treatment patients receive rather than their setting of care. It can be less expensive, for example, to receive an MRI in a physician's office than in a hospital setting.

Meanwhile, technology that will improve patient outcomes and help keep people out of the hospital—e.g., through telemedicine for follow-up visits—will change the nature and type of capital needed, shifting it from the physical plant to a technological infrastructure, with new medical devices, interoperable electronic health records (EHRs), and other innovations.

"We'll see a spike up in healthcare IT investments for EHR and post-acute patient care," says Pilch. "Technology ultimately will redefine the hospital of the future, with acute care hospitals serving as just one high-cost step along a continuum of care."

However, all is not diminishing, Pilch says. As physicians shift patients away from Medicare to Medicare Advantage, increasing options for payment from commercial insurers, hospitals may see an expansion of payment streams. ■

What You Need to Know

Healthcare leaders should anticipate four broad trends affecting healthcare financial services in the next few years.

- *An increase in short-term interest rates.* Such an increase may signal an increase in inflation, which in turn would drive up longer-term interest rates and increase the cost of capital.
- *An increase in the vulnerability of hospitals with slim operating margins and limited capital.* This trend, resulting from the increase in bundled and value-based payments and the move to outpatient care, will have the effect of reducing payments and leaving many hospital beds unoccupied.
- *The gradual phase-in of MACRA.* Implementation of this legislation will encourage the vertical integration of delivery systems and increase provider accountability for post-acute episodes of care.
- *Advances in technology.* Innovative new technologies will shift capital investments away from the physical plant to technologies that will further reduce acute care hospital revenue.