

What's Driving Margin Erosion in Healthcare?

Your Guide to Preventing Margin Erosion



Healthcare has a margin erosion problem.

The past few years have significantly destabilized the healthcare industry's financial footing. According to our [2023 Healthcare CFO Outlook Survey](#), 60% of healthcare CFOs could not meet the terms of their bond or loan covenants in 2022 — up from 41% in 2021.

As unfavorable economic conditions continue to pressure healthcare, providers must act to prevent further margin erosion and financial insecurity. Unfortunately, many providers are struggling with margin erosion dynamics that show no signs of resolving on their own. According to Fitch Ratings, it may take years for healthcare margins to recover to [pre-pandemic levels](#).

To improve margins and achieve greater financial stability, healthcare providers must first understand what's causing margin erosion. The following sections outline key drivers of margin erosion, their impact on the healthcare industry, and their expected duration.



High Labor and Contract Expenses

These expenses, which have trended upward over the past several years, have plateaued but show no signs of falling. Even with costs plateauing, April 2023's performance showed a [3% increase in labor expenses](#).

Impact: VERY HIGH

Expected Duration: ENDURING



Interest Rate Hikes

The Fed's recent interest rate hikes have increased the cost of borrowing. We could see further increases to the cost of capital as economic indicators like the [better-than-expected May 2023 jobs report](#) and wage increases may cause the Fed to bump rates up again later this year to cool ongoing inflation.

Impact: VERY HIGH

Expected Duration: ENDURING



High Inflation

High inflation increases costs in healthcare. May 2023's jobs report and wage rate increase data may prompt a Fed rate increase to offset ongoing inflationary pressures that, for example, have contributed to mortgage rate increases being their [highest since November 2022](#).

Impact: HIGH

Expected Duration: ENDURING



Low Capacity

Shifts in case mix are driving higher bed utilization. Hospital stays are also trending longer, due in part to heightened acuity resulting from delayed care during the pandemic. Furthermore, staffing shortages are contributing to a lack of capacity and a reduction in some cases of elective services.

Impact: HIGH

Expected Duration: ENDURING



Decreasing Commercial Coverage

Providers face lower reimbursement rates as coverage by nongovernmental organizations declines. This problem will worsen as an aging U.S. population leads to greater numbers of people covered under government programs, which provide lower reimbursement rates. An unfortunate outcome of the debt ceiling resolution is increased restrictions around employment requirements that may actually reduce the number of insured Americans, which will also extend to the Food Stamps program.

Impact: HIGH
Expected Duration: ENDURING



Supply Cost Increases

Supply costs continue to rise due to geopolitical disruption and lack of geographic diversity in supply chains.

Impact: MEDIUM-TO-HIGH
Expected Duration: ENDURING



Underperforming Real Estate

Real estate represents a high fixed cost that can quickly become a financial burden in the event of underperformance.

Impact: MEDIUM
Expected Duration:
If providers regularly assess and adjust their real estate holdings: SHORT TERM
If providers do not regularly assess and adjust their real estate holdings: ENDURING



Changing Sites of Care

Patients are increasingly seeking care from non-hospital sites of care that pull volume and revenue from provider systems that subsidize many physician groups and practices.

Impact: On hospital systems: HIGH
On non-hospital providers: MEDIUM
Expected Duration: ENDURING



Competition from Non-Traditional Entrants

Non-traditional entrants like retail and tech providers are taking market share away from traditional facilities.

Impact: HIGH
Expected Duration: ENDURING



Underperforming Assets

Underperforming service lines or specialty facilities can take a disproportionate amount of capital to maintain for very little ROI.

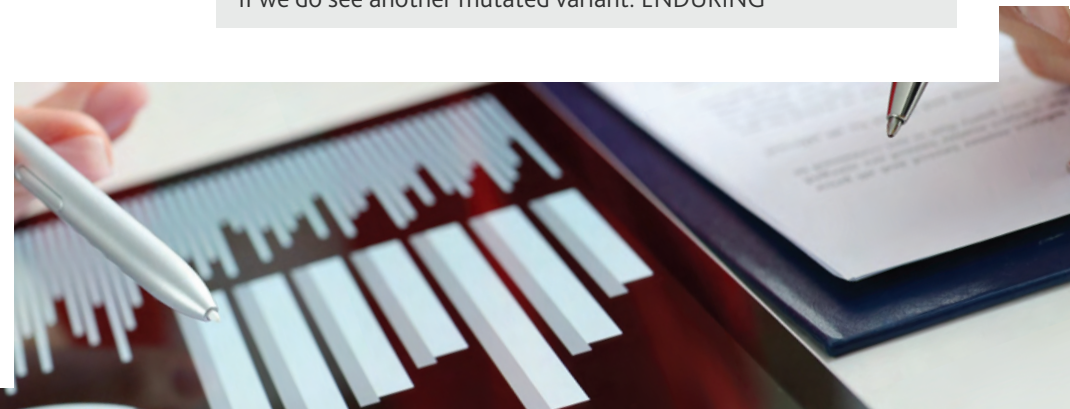
Impact: HIGH
Expected Duration:
If providers divest/lease/sell these assets: SHORT TERM
If providers maintain these assets: ENDURING



Lingering Impacts of COVID-19

Providers are catching up financially after COVID-19, with some still waiting to receive COVID-era payments and reimbursements. However, some organizations planned poorly for Paycheck Protection Program (PPP) repayments and are facing unplanned cash impacts.

Impact: LOW
Expected Duration:
If we do not see another mutated variant: SHORT TERM
If we do see another mutated variant: ENDURING



What can I do about margin erosion?



Many providers are tempted to solve margin erosion by cutting costs. Margin improvement, however, requires a long-term strategy and cost-cutting without a growth strategy is a shortsighted approach. While it may generate some immediate bottom-line improvement, it's unlikely to strengthen your financial foundation. On the other hand, developing a margin improvement strategy allows providers to gradually make structural changes that yield long-term results — and greater stability.

Need to establish a margin improvement strategy but not sure where to start? BDO's checklist below outlines the information you need and recommended steps you should take to develop your strategy.

PHASE I: Identifying Cost and Revenue Opportunities

- ▶ Benchmark your costs in the following areas against industry standards:
 - Provider and clinical support staffing
 - Pharmacy
 - Perioperative and procedural
 - Supply chain
 - Vendor management
 - Selling, general & administrative (SG&A)
 - IT
- ▶ Assess your revenue cycle management to identify gaps and inefficiencies.
- ▶ Review your patient access, demand, and capacity management to identify gaps and inefficiencies.
- ▶ Assess the profitability of each of your service lines.

PHASE II: Reviewing Balance Sheets

- ▶ Identify your priority strategic initiatives and determine the capital requirements to support them.
- ▶ Conduct a property, plant, and equipment (PP&E) assessment to determine if any assets should be sold, leased, or disposed of.
- ▶ Identify opportunities to deploy or reinvest working capital.
- ▶ Reevaluate your debt structure to assess your organization's current financial risk level.
- ▶ Determine whether you have any unclaimed property and, if so, review your state's regulations around reporting and refunds ahead of balance sheet transactions.
- ▶ Assess your management of assets like technical systems and medical equipment to identify gaps and inefficiencies.
- ▶ Identify opportunities to capitalize on R&D tax credits.

PHASE III:

Accelerating Digital Enablement

- ▶ Explore opportunities to leverage data and machine learning to reduce preventable readmissions.
- ▶ Offer expanded consumer-centric self-service tools with a side benefit of shifting work into the hands of patients.
- ▶ Assess your EHR platform to determine if it is properly integrated with your other systems and can support data-driven predictions.
- ▶ Prior to introducing new technology systems, evaluate their potential impact on and disruption to clinicians and administrative staff.

PHASE IV:

Exploring Partnership Opportunities

- ▶ Consider opportunities to partner and collaborate for functions such as IT, contact centers, and supply chain.
- ▶ Explore outsourcing and managed service arrangements to achieve efficiencies in core business operations.
- ▶ Critically evaluate mergers and integration opportunities to ensure they are patient-centric and focus on improving care at lower costs.

PHASE V:

Developing Your Workforce

- ▶ Consider how you can enable remote work opportunities to expand your talent pool.
- ▶ Invest in continuous learning to promote employee retention and satisfaction.
- ▶ Integrate advanced practice providers (APPs) across service lines.
- ▶ Invest in recruiting and training licensed practical nurses (LPNs) and medical assistants (MAs).

How BDO Can Help

Designing and deploying a margin improvement strategy is a serious undertaking that requires the right experience and support. We have a successful track record of transforming operations and improving margin performance for leading healthcare providers across the industry. Our in-depth insights and established methodologies help clients identify opportunities to drive margin performance and sustainability, all while focusing on a patient-centric approach.



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