10 Statistics to Analyze a Hospital’s Performance

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Kaufman Hall
At a Glance

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

MERGERS, ACQUISITIONS, AND DIVESTITURES
Kaufman Hall has advised clients on hundreds of M&A-related engagements including analyzing, structuring, negotiating, and executing mergers, acquisitions, divestitures, joint ventures, strategic partnerships and affiliations.

DEBT-RELATED FINANCIAL ADVISORY
Since 1985, Kaufman Hall has acted as financial advisor to more than 900 healthcare debt transactions. Total debt and swaps issued on behalf of our clients exceeds $90 billion and $43 billion, respectively.

FINANCIAL AND CAPITAL PLANNING
Introduced concept of strategic financial planning to healthcare field in 1983. Kaufman Hall has prepared financial and capital plans for over 800 hospitals and healthcare systems.

ENUFF SOFTWARE SUITE®
Over 1,300 software licenses are globally licensed. The ENUFF Software Suite uses corporate finance principles to directly support the financial management cycle.

STRATEGIC SERVICES
Kaufman Hall provides a broad range of M&A-related services to support organizational management and decision-making. Kaufman Hall pioneered the development of the integrated strategic financial plan.

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

- 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

<table>
<thead>
<tr>
<th>Core Competency Areas</th>
<th>Key Characteristics of the Best Prepared</th>
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<tr>
<td>Physician/Hospital Integration</td>
<td>Highly aligned medical staff characterized by shared goals, contractual arrangements, significant planning, and adequately represented in organizational governance.</td>
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<td>Care Coordination/Management Capability</td>
<td>Use of care coordination tools and processes by an empowered and integrated workforce to drive performance goals that are regularly measured and reported.</td>
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<td>Information Systems Sophistication</td>
<td>An IT platform that supports clinical decision making, information management, facile communication, and access to all stakeholders (physicians, patients, administration) to proper treatment and strategic decision making.</td>
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<td>Service Distribution System/Effectiveness</td>
<td>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.</td>
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<tr>
<td>Cost Management</td>
<td>A high-level organization-wide cost structure, highlighted by appropriate levels of staffing, capital spending, overhead support, and supply chain costs, consistently measured based on comparative peer group studies and benchmarks.</td>
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<td>Scale and Market Essentiality</td>
<td>Sufficient scale to attract competitive clinical and administrative talent, realize economies, drive market share growth, and be an essential provider to health plans and patients.</td>
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<td>Brand Identification</td>
<td>Well recognized and respected, associated with high-quality and service excellence.</td>
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<td>Payor Relationships/Contracts</td>
<td>Maintaining strong relationships with payors and the ability to negotiate support for &quot;new era&quot; business practices.</td>
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<tr>
<td>Financial Strength/Capital Capacity</td>
<td>Setting apart to capital markets through sustained operations, revenue growth, and balanced sheet strength.</td>
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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

Balancing sources and uses

What Levers Do We Have to Work With?


Philanthropy and Other Sources?

Cash Debt Capital Operations

How should these tradeoffs be optimized within an appropriate credit and risk context?
### Definitions of Key Financial Ratios

#### Operating Margin
- **Operating Margin**: Operating Income / Total Operating Revenue

#### Operating EBITDA Margin
- **Operating EBITDA Margin**: Operating Income + Depreciation, Amortization and Interest / Total Operating Revenue

#### Days Cash on Hand
- **Days Cash on Hand**: Cash and Marketable Securities + Board Designated Funds / Annual Depreciation Expense

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

#### Debt to Capitalization
- **Debt to Capitalization**: Long-term Debt + Short-term Debt / Total Debt

#### Days in Accounts Receivable
- **Days in Accounts Receivable**: Accounts Receivable x 365 / Net Patient Revenue

#### Average Age of Plant
- **Average Age of Plant**: Accumulated Depreciation / Annual Depreciation Expense

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

### Financial Ratio Explanations

#### Operating Profitability
- **Operating margin**: reflects the profitability of an organization from its active patient care and related operations.
- **Operating EBITDA 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 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**: measures how much personnel expenses are required to generate one dollar of revenues.
Appendix: Financial Statements

The Three Key Financial Statements

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<th>Income Statement</th>
<th>Balance Sheet</th>
<th>Statement of Cash Flow</th>
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<tr>
<td><strong>What Does it Tell Us?</strong></td>
<td><strong>Revenue - Expenses = Profitability</strong></td>
<td><strong>Snapshot of</strong></td>
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<td><strong>Things You Might/Might Not Already Know</strong></td>
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<td><strong>Where you find info on cash balances, debt</strong></td>
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<td><strong>Statement that tells us the most about an organization’s financial health</strong></td>
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<td><strong>Snapshot of a point in time</strong></td>
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<td><strong>Divides cash flows into 3 groupings: Operating, Investing, and Financing</strong></td>
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<td><strong>Provides context for Income Stmt and Bal Sheet</strong></td>
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**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

Cash & Capital Spending
Debt & Borrowing

Key Questions
How much cash does an organization need?
How much debt can it afford?