

STRATEGY CHALLENGE

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What Would You Do?

is independence the right strategy?

The Problem

Suburban General Hospital (SGH) is a strong free-standing community hospital in the growing suburbs of a major metropolitan area. SGH has flourished as an independent hospital. While the metropolitan area market in which it operates is in the midst of a consolidation frenzy, can and should SGH remain independent?

The Situation

SGH is a 300-bed general acute care hospital operating near the periphery of a major metropolitan area. The hospital provides a broad range of secondary care and limited tertiary care, and has high patient satisfaction and good quality scores. SGH has a largely voluntary medical staff of about 400 active physicians. A recently completed major facility modernization project has created a completely updated physical plant. Despite having taken on significant debt to finance the modernization project, SGH's financial performance continues to be good, and its financial position, although heavily leveraged and less liquid, is stable and solid. SGH's position is summarized in the exhibit below.

SGH is located in a rapidly growing middle-class market, with population growing about 1.5 percent per year. It has a good payer mix, with about 60 percent commercial insurance (two-thirds of which is PPO), 35 percent Medicare, and small amounts of Medicaid, self-pay/cash, and other minor payers.

Historically, competition in SGH's service area has been modest. Other community hospitals are located 10 or more miles away, and despite minor overlaps on the fringes of each hospital's service area, competition has been almost nonexistent. However, in the past five years, major medical centers in the city have developed freestanding ambulatory care centers in SGH's market, and these medical centers have acquired some local physician practices. In the past 12 months, the medical centers have also become aggressive in developing systems, with four of the five formerly independent hospitals in SGH's county having been absorbed into the systems. In fact, due to consolidation throughout the metropolitan area, 55 of the 75 hospitals are now in one of eight systems, and five of the 20 remaining independents are reported to be in discussions to join the systems.

SUBURBAN GENERAL HOSPITAL: FINANCIAL SUMMARY, FY11

Balance Sheet		Income Statement	
Current assets	\$142,200,000	Total charges	\$1,237,300,000
Fixed assets	\$287,400,000	Contract allowance	\$919,000,000
Other assets	\$81,600,000	Operating revenue	\$318,300,000
Total assets	\$511,200,000	Operating expense	\$309,100,000
Current liabilities	\$71,300,000	Operating margin	\$9,200,000
Long-term liabilities	\$305,600,000	Other income	\$3,500,000
Total equity	\$134,300,000	Other expense	\$0
Total liabilities and equity	\$511,200,000	Net profit or loss	\$12,700,000

SGH's board and senior management are resolute in their desire to remain freestanding. They have formed strategic alliances with three of the medical centers/systems to supplement their service offerings in cancer, pediatrics, and rehabilitation (employing a "best-of-breed" strategy)—a strategy also intended to keep them at bay. However, with the dominos falling around them, and with SGH's financial position weakened because of its additional debt burden, a number of the trustees are voicing concerns about the viability and desirability of SGH's independent posture. The board chair has decided to convene an ad hoc committee

to study the issue and make a recommendation to the full board on how to proceed.

Alternatives Considered

The ad hoc committee has decided to limit its time horizon on the preferred strategy to the next three years, given all the uncertainties in the current environment. Trustees have agreed that although there are two main alternatives (an independent course and an affiliated one), these alternatives are, in reality, different points on a continuum from totally freestanding to fully merged and that many possible hybrid combinations exist between these polar opposites. Recognizing the strong desire of many leaders for SGH to remain as independent as possible, the ad hoc committee has decided to focus first on whether and how this might be achievable.

To support the committee's deliberations and expedite its work, SGH has retained the services of a consultant with experience in affiliations. The consultant's previous research identified 10 indicators that were correlated with the ability and desirability of a hospital to remain largely independent. A summary of its findings for SGH with respect to these indicators is shown in the exhibit below.

STRATEGIC POSITION OF SUBURBAN GENERAL HOSPITAL: KEY INDICATORS

Dominant market share; overall and clinical program-specific
High-quality services, aligned clinicians, and adequate supply
Market equilibrium for supply and demand
Low cost structure
Adequate net assets/reserves
Greater liquidity
Less debt on hand
Low age of plant
Favorable payer mix
Good leadership breadth and depth

Performance Level

■ Strong
 ■ Moderate
 ■ Weak

As the exhibit shows, with the exception of a few important indicators, SGH's position is favorable. However, the analysis also discloses two areas of concern: SGH's loose alignment with its physicians makes it vulnerable to having its medical staff picked off by competitors, and it has only modest reserves, coupled with a heavy debt load. According to the consultant's prior experience, all 10 indicators should be favorable (green) if a hospital is truly to have a strong likelihood of thriving, not just surviving, over a three-year time horizon in a highly competitive market.

With the consultant having presented a report and findings, the ad hoc committee is engaged in a lengthy and spirited debate about the report and its implications for SGH. Given the above, what decision should the ad hoc committee make?

The Decision

A vocal group of trustees and the CEO argued that the consultant's findings were flawed and that SGH's competitive and financial positions are extremely strong and capable of carrying it through the impending storms, and that the storm forecast was overstated. The CFO, however, expressed great concern about SGH's weakened financial position and how that boded for the future. Many trustees drew on their own experience outside of health care to argue that the value of independence was overstated, and joining a strong system could well be in the best interest of ensuring the future provision of high-quality health care to SGH's community.

In the end, the ad hoc committee was deadlocked. Recognizing that no decision was, in fact, a decision by default, the board chair decided to convene a board retreat to address the issue. He invited the consultant to present the report to the whole board and for the executive team to present a comprehensive analysis of the pros and cons of each alternative. The daylong retreat culminated in a 12-8 vote of the board to begin to pursue an affiliation and to extend invitations to five area systems asking each to present SGH's leadership with a case for SGH to join its system. ●

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