

# *Achieving Peak Performance through Strategic Visioning*

BY NATHAN S. KAUFMAN

In little more than a year, the disparity between peak performing hospitals and their peers has widened. While the American Hospital Association warns that “many American hospitals are sitting on the edge of fiscal viability,” (“State of Hospitals’ Financial Health,” 2002) many investor-owned hospital systems are reporting growth in profitability. Tenet recently reported a record 13 percent operating margin, and HCA reported its 20th quarter of double-digit growth in earnings. Many of these record earnings can be attributed to a focus by these systems on peak performance status.

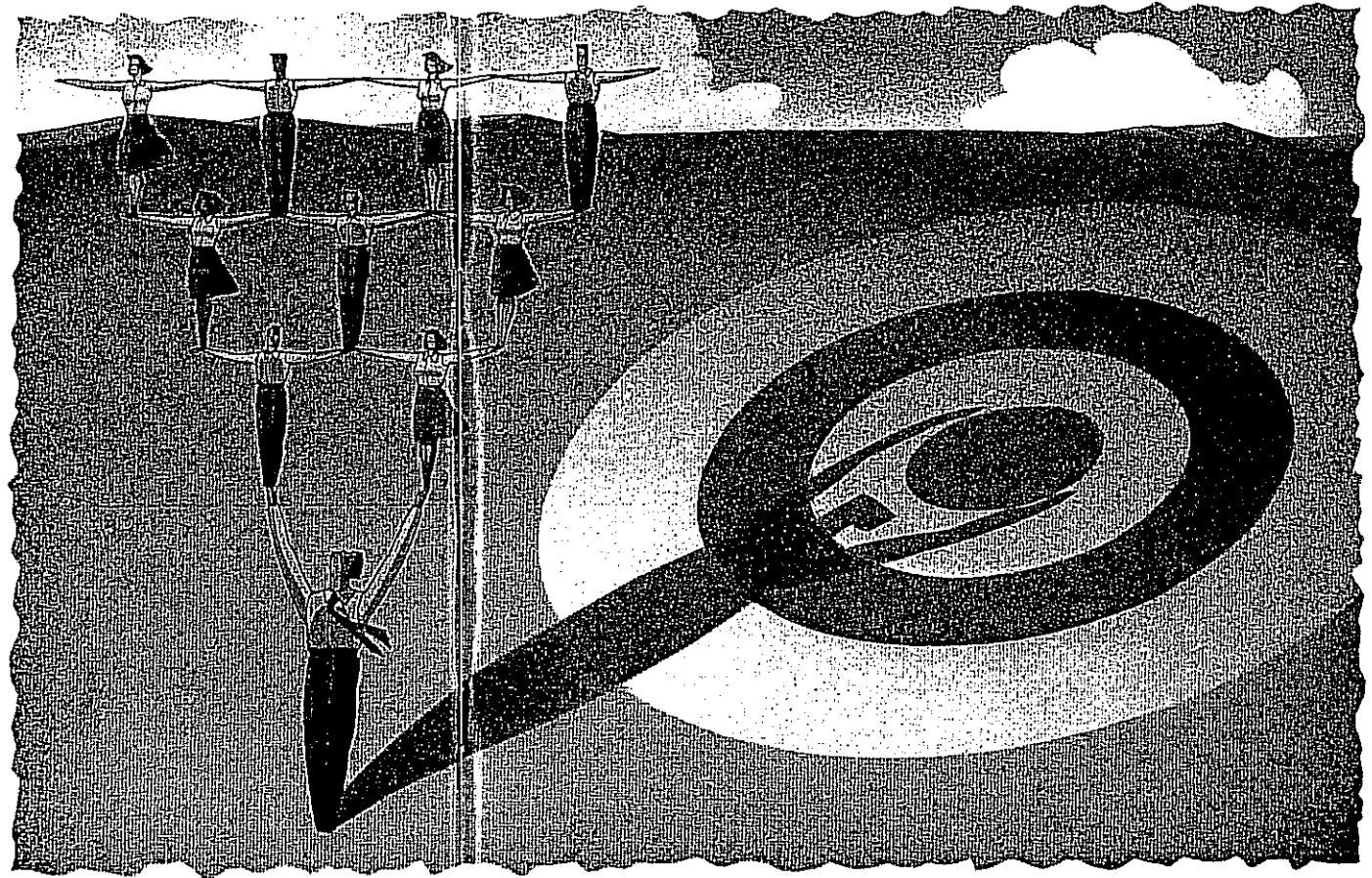


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## Capital and Financial Solvency: A Primary Mission

Hospitals have an insatiable appetite for capital. Facilities and equipment become obsolete within five to ten years. New technology, rising construction costs, and the need for comprehensive information systems are all driving the need for capital. In most cases, hospitals with access to the least costly capital will dominate their markets. Thus, understanding and meeting the funding criteria for low-cost capital is paramount for sustaining peak performance in a health care organization. The capital markets use the following quantitative business criteria to determine the availability and cost of capital for a hospital: amount of debt; funds in reserve; and cash flow.

Strong financial performance ensures that relatively inexpensive funding will be available to upgrade and expand a hospital. Weak financial performance will result in depleting reserves, high capital costs, eroding quality, and eventual hospital closure or sale. In 2001, an estimated 35 tax-exempt hospitals were sold to investor-owned systems because of their poor financial performance. Regardless of sponsorship, hospital trustees must recognize that one of their primary missions is to guide the hospital to achieve exceptional financial performance; that is, having an operating margin of five percent or better. High profitability enables the hospital to treat the medically indigent and provide other mission-related services.

## Developing a Performance Culture

Peak performing hospitals have a performance culture characterized by the establishment of quantitative benchmarks that require commitment and effort to reach. Once established, these targets are non-negotiable. Performance is evaluated within the organization based on achieving these benchmarks. Should the hospital underperform, management is required to take immediate action and bring the organization's performance back to an acceptable level. Finally, if the hospital continues to underperform consistently, personnel changes need to be made. For managers, the risks within a performance culture are high, but so are the rewards—high-performing managers receive significant merit-based compensation.

## Strategies to Achieve Peak Performance

Peak performing hospitals and systems employ three key management disciplines: portfolio management; focus/resolve to achieve quantitative benchmarks; and informed, objective decisionmaking.

**Portfolio Management.** Portfolio management is defined as the right hospital with the right services in the right place. This major driver for peak performance rarely happens by chance. Both HCA and Tenet have adopted a strategy of regional dominance: neither company will enter a new market unless it believes it can capture a critical mass, i.e., a minimum of 20 percent of that market. Specific tactics for managing a hospital portfolio include:

- Sell, merge, or close hospitals with weak market position and poor performance. These hospitals are a major drain on scarce capital and rarely turn around regardless of the dollars invested. HCA cut its losses in Atlanta by closing Parkway Regional and West Paces Ferry Hospitals. Tenet closed St. Luke's

in Pasadena, Calif. A system should not suffer when the community is unwilling to support one of its facilities.

- Limit management focus to the core business. A hospital is one of the most complex businesses to operate. Related, but non-core services, such as home health care, skilled nursing care, and health clubs operate at a deficit, dilute management focus, and ultimately hurt the hospital's ability to access less expensive capital. If a peripheral service is operating at a deficit, in most cases, the hospital should eliminate it. Instead, the hospital should promote the delivery of peripheral services by other niche providers and coordinate care with those providers.

**Focus/Resolve to Achieve Quantitative Benchmarks.** Pricing and expense control are the primary tactics here. Occupancy rates for hospital beds bottomed out in 1997-98 and are now rapidly increasing. Diminishing capacity in the system is exacerbated by the shortage of both ICU beds and key hospital personnel, e.g., nurses, physical therapists, etc. This has created an extremely favorable environment in which hospitals can demand the prices they need to achieve peak performance.

In 2001, HCA and Tenet combined, achieved a 7.8 percent increase in net revenue per patient day. This increase could have only been achieved by double-digit increases from commercial and managed care plans. Anecdotal information and personal experience with tax-exempt hospitals support the premise that any hospital with a strong regional presence that is willing to walk away from a payer offering a bad contract can achieve significant rate increases.

Hospital supply and personnel costs are escalating at 5 to 10 percent per year. Medicare rates are only increasing by two to three percent. Aggressive pricing is the only option a hospital has to maintain consistent revenue and profit growth.

A common rationale used for pricing hospital services below their cost is "contribution margin." Some believe that it is good to accept any revenue from a payer that covers the variable costs of providing care and, thus, "contributes" to the fixed costs of the facility. The airline industry has used contribution margin pricing for years, and it has not worked successfully. Eventually all customers migrate to pricing based on the contribution margin, and no one pays full price. Hospitals that are losing money on Medicare/Medicaid payments (which usually represents at least 50 percent of the hospital's revenue) must cover their total costs (and more) with payments from commercial payers and, thus, should not price their services based on contribution margin.

Expense discipline is the other tactic necessary to achieve quantitative benchmarks. All expenses within a hospital must be benchmarked and measured routinely. By adopting the culture of performance, department managers understand that their job is to run the department within non-negotiable financial parameters. In addition, the medical staff leadership must work to reduce supply and personnel costs. It is critical that physicians see the fruits of their labor in the form of increased capital expenditures for the facility.

**Make Decisions Based on Objective Information.** Hospital trustees are faced with extremely complex decisions that rarely have obvious, simple solutions. Decisionmaking becomes easier once trustees accept that the success of a hospital over the

# Strategic Vision

Critical Performance Indicators (CPI)	Possible Target
Operating margin	>5%
EBDITA (Earnings Before Depreciation, Interest, Taxes, and Amortization)	>15%
Personnel expense (i.e., salaries, wages, benefits, agency fees)	<45 % of net revenue, 5.0 employee per AADC (Adjusted Average Daily Census)
Supply expense	<16% of net revenue
Annual growth in net revenue, per adjusted patient day <i>[A calculation that converts outpatient visits to equivalent inpatient utilization]</i>	>6%
Annual growth in net revenue	>8%
Inpatient surgeries per 100 admissions	>28
Bad debts as a percent of net revenue	<8% of net revenue
Accounts receivable	<65 days
Annual growth in emergency department visits	>3%
Other key services	To be determined
RN turnover	To be determined
Employee turnover	To be determined
Patient satisfaction	To be determined
Quality indicators	To be determined

NOTE: TARGETS CAN BE MODIFIED SLIGHTLY TO REFLECT MARKET CONDITIONS.  
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long term depends on the hospital's performance as a business.

Key elements to make appropriate decisions are:

- Place the greatest weight for making any decision on financial analysis that is based on reasonable assumptions.
- Avoid theoretical, qualitative rationales; for example: "We may lose money, but ultimately it will be better for the patients." In other words, if you can't prove it, don't believe it.
- Mission is not an excuse for poor performance. The financial impact of mission-related activities must be quantified and controlled. For example, losing a predetermined amount of money on a free clinic is a rational decision; claiming mission as an excuse for out-of-control supply costs is not.
- Focus on essential hospital services. Hospitals are highly complex organizations requiring intensive management focus. Hospitals that deliver services that are outside their core competency dilute scarce management resources and capital. Hospitals must focus on essential hospital services, especially the emergency department, the intensive care unit, inpatient surgery, and cardiology. These are essential hospital services and require the majority of the organization's capital investment and management attention.

## Strategic Visioning

Most hospitals have developed qualitative mission and vision statements, e.g., "to be the provider of state-of-the-art quality services." These mission and vision statements serve little pur-

pose if they do not tie into the hospital's operations and if they cannot be quantified (thus they will not be achieved).

Strategic visioning is a process of defining the future vision of the hospital using measurable critical performance indicators (CPI). These indicators are based on an objective assessment of the environment, which identifies what the hospital must do to capture market share and achieve the necessary financial performance.

The CPIs provide the hospital board with a framework for regularly assessing the hospital's performance. When a hospital underperforms with respect to its critical performance indicators, it is a warning that it will not be able to achieve its strategic vision. Thus, an action plan must be initiated to bring performance in line with the CPIs. The above chart provides an example of the types of CPIs that make up a hospital's strategic vision.

The community has entrusted hospital boards with the awesome responsibility of governing their local hospital. Financial performance is a significant measure of the board's stewardship. Understanding the drivers of peak performance and using strategic visioning to guide the institution are essential tools of hospital trustees. **T**

NATHAN S. KAUFMAN is senior vice president for health care strategy, Superior Consultant Holdings Corp., San Diego. He can be reached at (858) 487-9771.