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THE ROAD TO FINANCIAL STABILITY: How health system leaders are navigating razor-thin margins



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Approximately half of U.S. hospitals finished 2022 with negative margins, marking it the worst financial year for hospitals since the onset of the COVID-19 pandemic. While margins have stabilized somewhat in 2023, with some hospitals seeing modest improvements, hospital finances remain precarious and extremely challenging.

To better understand how hospital and health system leaders are navigating razor-thin margins, *Becker's Hospital Review* conducted an advisory call with CEOs, CFOs and vice presidents of finance and operations from health systems across the country. *Becker's* also spoke with Ken Leonczyk, senior vice president, provider partnership strategy at Optum. The advisory call participants and Mr. Leonczyk shared their perspectives on factors contributing to margin pressures, what actions hospitals and health systems are taking to address these challenges, and an outlook for the future.

Why margins are under such tremendous pressure

Hospital and health system leaders are in strong agreement that the leading factor contributing to margin erosion has been exploding labor costs. The CFO of a health system with 11,000-plus employees based in the Mid-Atlantic U.S. said labor costs typically represent 50 to 60 percent of a healthcare service organization's total costs. Data from Advisory Board shows that from December 2019 to December 2022, labor expense per adjusted discharge increased by 26 percent.

A key driver of increased labor costs has been "skyrocketing agency rates," said the CFO of an academic medical center based on the East Coast, referring to the high costs paid to external staffing agencies, especially for nursing talent. "Our rate at one point was up to $200 an hour for agency staff." The chief strategy officer from another health system based on the West Coast agreed. "Contract labor has been our biggest challenge over the last couple of years," he said. "We hit a high of $240 an hour for travel nurses, resulting in spending about $40 million last year on contract nurses." Leaders confirmed skyrocketing labor costs for non-clinical talent, too.

In addition to soaring labor costs, hospitals have also experienced rapidly rising drug costs and rising costs for other supplies used in hospitals and health systems. These cost increases are attributable to persistent inflation and lingering supply chain issues.

Reimbursements have not kept pace with increased costs. This includes Medicaid and Medicare reimbursement, and reimbursement from private payers. "We are seeing ongoing issues with Medicaid reimbursement being a challenge," said the CEO of a health system based in the South where more than 50 percent of patients are covered by Medicaid, which offers low reimbursement rates. In 2020, hospitals received only 88 cents for every dollar spent caring for Medicaid patients, according to data compiled by the American Hospital Association.



'This is different'

"The reality is that hospitals have always faced margin issues to some extent," Mr. Leonczyk said. "But this is different." Previously, hospitals tended to experience margin pressures on a cyclical basis. When this occurred, hospitals would tighten their belts, make some short-term operational changes, weather the storm and then eventually the cycle would improve. "We are not facing the traditional cyclical shift that happens where something rough occurs and then things return to normal," Mr. Leonczyk said.

What is occurring right now is more significant and likely to create lasting change. "We are in the midst of a secular shift for health systems, for hospitals, for the entire delivery system, for the payment system — and a secular shift in the culture," Mr. Leonczyk said.

He attributed this shift to:

- **Changing patient expectations** around how care is provided, including expectations involving digital tools. Patients increasingly want and expect the same level of convenience and personalization they experience with online retailers.
- **Changing employee expectations** related to work-life balance and participation in the "gig economy." Post-pandemic, healthcare employees want more control and greater flexibility.
- **Changing employer demands** for cost containment in an environment where more than 70 percent of employers expect moderate to significant increases in healthcare costs in the coming years.
- **Changing payer dynamics**, with payers increasingly focused on value-based care, whole-person care and preventive care to preclude and avoid expensive procedures and treatments.

These macro forces are driving major change in healthcare, which is very different from previous cyclical periods of margin compression and expansion. Navigating these systemic changes in an inflationary environment will require both immediate action and long-term planning.

How organizations are responding right now

Leaders recognize that simply waiting for margins to improve is not an option. Here are some of the actions hospitals and health systems are taking to navigate the current fiscal environment:

- **Decreasing reliance on contract labor.** Hospitals and health systems are working to decrease the use of costly contract labor. Many have made progress. Some advisory call participants said they'd reduced contract labor usage by 50 to 75 percent. Strategies to reduce contract labor include hiring more full- and part-time employees and working to improve retention through increased engagement and flexibility. One health system has even opened its own nursing school to "grow their own," an idea that resonated with other health system leaders on the call.

- **Placing greater scrutiny on cost management.** Managing costs has long been a priority, but based on the current margin crisis, it is essential to develop new strategies and approaches for cost management. The chief strategy officer from the hospital on the West Coast said the greatest lesson from the current crisis is the importance of seizing the opportunity to get leaner and more efficient. Some health systems have undertaken a reduction in force, where possible, with others increasing the focus on supply chain costs. A common strategy involves increasing the focus on reducing length of stay – which increased by 11 percent between December 2019 and December 2022 – while also working to reduce ED utilization and readmissions. Higher length of stay, ED use and readmissions collectively "destroy profitability," one advisory call participant said. A CFO described an effort to get patients to the "lowest cost of care setting," which for patients with congestive heart failure might be a cardiologist's office or a PCP's office, instead of an ED. Another strategy is accelerating the movement toward value-based care, which changes everyone's incentives to be more efficient and cost-effective.

- **Narrowing the scope of offerings to a set of profitable, mission-aligned services.** To conserve cash, hospitals and health systems are evaluating every service line, facility and potential investment. These evaluations are leading to hard but necessary choices to exit some unprofitable service lines, close some unprofitable facilities and/or delay investments or initiatives that would consume cash in the near term but would not deliver profitable returns for some time. The chief strategy officer said his organization has delayed a hospital-at-home initiative for at least one year to preserve cash and achieve greater financial stability. Mr. Leonczyk sees many organizations deciding to "pause or cancel efforts that are not core to their mission." The CEO from the Mid-Atlantic health system stressed the importance of "saying no" at this moment.

  However, a CFO emphasized that simply saying no is not enough. It is important to health system leaders to connect and communicate how strategic initiatives – that are being pursued or delayed – impact the organization's financial health. "You've got to be able to connect your strategic initiatives to bottom-line impact – to the balance sheet and cash flow," he said. All employees on the team need to understand the rationale for decisions.

These actions require identifying services that are most profitable, increasing the focus on these offerings and then working to improve the profitability of unprofitable offerings or discontinuing them.





An opportunity to engage in longer-term strategic planning

While navigating tighter hospital margins has, out of necessity, increased the focus on capital preservation, Mr. Leonczyk pointed out that current financial challenges also present a unique opportunity. The opportunity is to go beyond being hyper-focused on the present, which is necessary but not sufficient, and to "stop, think and plan strategically for the future."

Thinking strategically involves answering questions about how the organization will best serve its community in the future and how the organization will grow over the next three to five years. While rationalizing services and scaling back investments may be necessary in the short term, organizations need to develop long-term plans to drive growth. This includes continuing to invest in strategic areas and initiatives that directly drive revenue, with relatively minimal capital investment, such as hiring key staff members – especially primary care physicians. "We know that the future of healthcare, if done correctly, means that PCPs are going to help manage the cost of care," the CEO of a health system in the Southeast said.

Also, health systems are exploring opportunities to provide existing services in lower-cost care settings. While the specifics will vary for every health system, examples being considered or pursued include retail clinics and home care.

Mr. Leonczyk said future-focused organizations are working to break clinical silos by embracing the concept of "whole-person care." He also said hospitals and health systems are rethinking their organizational structure and workflows, along with increasing their focus on the patient financial experience.

Partnerships as a key strategic consideration

When making long-term strategic plans, it's important to consider outside partnerships. This involves hospitals and health systems assessing what they will do themselves and where they may be able to enlist a third party that can provide capital, technology or expertise in a particular service area. In today's low-margin environment, partnerships may provide a way to protect or enhance existing margins while driving revenue growth in a particular service area without capital investment.

The chief strategy officer of a health system said, "Our ability to invest in new equipment and services and new facilities is really going to be limited going forward. So, as we think about a/our new ambulatory surgery center, we're having to look at partners, where in the past we probably would have built the center ourselves."

Mr. Leonczyk said partnerships should "allow hospitals and health systems to focus on doing themselves what they do well, while having partners take on services or technologies for them." "I believe health systems now, more than ever, need real partnerships as opposed to myriad vendors."

Mr. Leonczyk said he is encouraged to hear that so many organizations are choosing to engage in partnerships that enable a hospital or health system to increase their focus on clinical care, on improving the patient experience and on fulfilling the organization's mission.



Conclusion

The margin pressures faced by hospitals and health systems today are unprecedented and represent a paradigm shift in the industry. Out of necessity, leaders are taking urgent, immediate actions to address their organizations' razor-thin margins. These actions include decreasing reliance on costly contract labor and increasing scrutiny on cost management. However, just focusing on near-term issues is not enough; it is also essential to take a longer-term perspective by engaging in strategic planning.

Looking at the strategy over a longer time horizon involves being laser focused on how best to serve the community, emphasizing whole-person care and identifying growth opportunities. This strategic planning process may involve narrowing the scope of service offerings, making investments in hiring and technology, and choosing to partner so staff can remain focused on the most important patient-facing activities.