Practice Case 11 (Hospital)

Question

Our client is a 350-bed hospital in a mid-size city. The organization has historically exhibited strong financial performance, and had a 1-3% operating gain each year for the last five years. However, they are projecting a $12 million operating loss this year, and expect this situation to worsen in the future. As a result, the CFO believes that they will be out of cash within five years. They have asked us to identify the source of this sudden downturn, and to come up with alternatives to restore them to a break-even position. They are one of the largest employers in the market, and will not consider layoffs as a possible solution.

Background

This question addresses company profitability. The interviewer is looking for a candidate's business intuition and ability to apply this intuition to identify potential sources of the problem. In addition, the interviewer is looking for potential solutions to the client's problem.

Response

Candidate: Profitability is a function of an operation's revenues and costs. The first thing I'd like to focus on is the company's future revenue stream. As I understand the hospital industry, revenues may be fixed for several years due to long-term contracts with insurers. Is this the case for this hospital?

Interviewer: Your intuition is correct. Revenues have dropped approximately 15% so far this year due to aggressive pricing on capitated managed care contracts that were signed in January and declining admissions and length of stay for their fee-for-service contracts, most of which are still reimbursed on a per diem basis. All contracts are binding for three years, and cannot be renegotiated.

Candidate: In that case, it is important to understand the company's cost structure to see if it can adjust to this declining stream of revenue. Does the client have considerable fixed costs that will be difficult to reduce in the near term?

Interviewer: Hospital occupancy is approximately 70%, resulting in high fixed costs that are not covered by the current contribution margin. The organization is currently staffed for 80% occupancy.

Candidate: Since revenue is declining at a fixed rate and fixed costs are high in the short-term, the hospital will have to analyze its variable cost structure. I would surmise that staffing costs are the main source of variable costs. However, the hospital cannot address this due to its policy concerning layoffs. I would think that the other main driver of variable costs for the hospital lies in its utilization of resources. Am I headed down the right track?

Interviewer: In fact, you're right. The utilization of diagnostic and therapeutic services during a patient's stay is approximately 15% higher than what was expected when contract pricing was negotiated.

Candidate: Given that information, the hospital should focus on changing physician behavior since physicians ultimately control the utilization of resources. The hospital may want to align MD incentives with those of the hospital by sharing risk, giving physicians data and education on their use of resources versus the competition. Other ways to reduce expenses could be to sign exclusive contracts with a distributor in order to generate volume discounts and economies in purchasing, or by reducing choice by limiting the pharmacy formulary to generics and decreasing the number of vendors utilized for high volume items such as prosthetics and heart catheters.

Interviewer: That's a good discussion of cost implications, but have you given up on recommending ways to increase hospital revenue?

Candidate: Now that you mention it, the situation is not hopeless in this regard. The hospital may want to increase revenue by signing contracts with additional insurers, by putting salaried physicians on staff to guarantee that they admit to our client's hospital, or by creating an affiliated physician organization to increase their share of admissions. In addition, they can potentially leverage their distinctive competencies by developing Centers of Excellence that can be marketed to managed care contractors as an exclusive provider for those services within the region, and possibly outside the region.

Interviewer: Are there any other solutions that may be feasible?

Candidate: One final thought that keeps coming back to me centers on the company's current competitors. What does the local market look like?

Interviewer: There are two other 350-bed hospitals in the city. One is an academic medical center, the other a catholic hospital recently acquired by a for-profit chain. Additionally, total admissions in the marketplace have dropped by 5% and total patient days have declined 10%.

Candidate: In that case the hospital may want to consider affiliating with a competitor in the market. This may help to decrease capacity across the city by rationalizing the services offered at each institution. This may allow one hospital to close, thereby reducing fixed costs.

General Summary Comments

The candidate should fully address the components of this issue (profit = revenue - costs) and should be able to demonstrate an understanding of fixed vs. variable costs. Moreover, the candidate should be able to brainstorm possible solutions to the problem, both from a revenue maximization and cost minimization perspective.