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No margin, no transformation

Why not-for-profit health systems need positive margin

Margins must improve if the industry is to continue providing high-quality, equitable care and transform to address consumers' needs.

Health care providers on the thin edge of margin

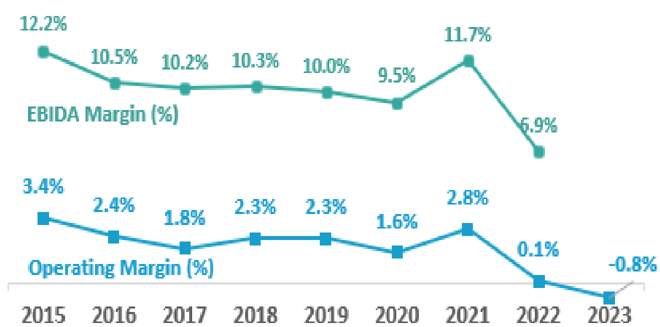
Operating margin—the difference between an organization's revenues and its costs—is one of the most critical and publicized financial metrics. This is especially true for the not-for-profit health care provider industry, which has recently experienced historically low margins. A lot of scrutiny exists because of their not-for-profit status, but at the same time, margins must improve if the industry is to continue providing high-quality, equitable care in technologically advanced facilities and make investments to address consumers' demands.

There is an emerging sense of resignation that these historically low margins will persist and may be a "new normal" in which many not-for-profit health systems cease to generate positive margins.[1] Furthermore, there are some that would accuse health systems of putting profits ahead of their mission to serve the community, without an honest consideration of just how these health systems can even serve their mission without a healthy margin.[2]

And yet, in 2022, the American Hospital Association (AHA) noted more than half of US hospitals had a negative margin.[3] In the latest S&P Global Ratings report of not-for-profit hospitals, average operating margins reached an eight-year low in September 2023 at –0.8%, well-below historical levels of up to 3.4% (figure 1), while Deloitte's survey of health care C-suite executives showed only 3% have a positive outlook on the industry for 2024 compared to 15% last year.[4]

Figure 1

Not-for-profit Acute Healthcare Operating Margin and EBIDA Medians (2015-2023)



Source: S&P Global Ratings

Operating margins reached an eight-year low of **–0.8%** in 2023.

Margins must improve if the industry is to continue providing high-quality, equitable care.

Why margin is required for healthy health systems

Numerous peer-reviewed studies have substantiated the positive correlation between hospital financial performance and quality and safety at the macro level. One study found that "financially stable hospitals have better patient experience, lower readmission rates, and show[ed] evidence of decreased risk of adverse patient quality and safety outcomes,"[5] while a large literature review concluded that in nearly half of the studies, the association between financial performance and quality was positive—with no study showing a negative correlation.[6] And looking more closely at the positive correlation, another study found quality rises in the year following an increase in hospital profitability, while Deloitte has shown that patient experience is also correlated to financial performance.[7]

Important factors for why margin is so important for health care providers include:

- Routine capital replacement. The ongoing demand to maintain, update, reconfigure, and eventually rebuild complex facilities, equipment, supplies, and devices, as a result of the health care industry's capital-intensive nature and the expectation to keep pace with evolving models of care, such as ambulatory surgery centers, new urgent care clinics, or in-home care.
- Community benefit. The significant amount of community benefits provided—such as direct charity care, unreimbursed health profession expenses, and operating facilities that generate minimal financial return but offer wide access to the health system—that are not offset by revenue. Health systems also are often the top employer in their communities, underscoring the importance of their financial health.
- Complex care. The need for many health care providers providing complex services, such as academic medical centers or urban hospitals, to hold a high amount of capital and reinvestment in property, plant, and equipment while serving a relatively large Medicaid or underinsured population that generates a lower level of reimbursement.

Case in point

Let's look at a real, specific example in which a demonstrable change in margin is linked to improved quality. Two health systems that came together in 2018 recognized that their favorable margin position would allow them to advance their shared mission and reinvest in community benefits, which were estimated to total $2 million per day. Both organizations collaborated to identify initial projected annual savings of $200 million. Three years later, however, the total realized annual savings was $370 million, exceeding the original target. Quality scores were also impressive, with double-digit decreases in the rate of all-cause mortality, heart failure readmissions, and sepsis mortality.[8]

Even more margin is required to transform

Beyond routine capital investments, the health care industry is undergoing a significant and continuous innovation and reinvention, requiring health systems to make additional strategic investments to address evolving consumer demand for improved access, equitable outcomes/quality, convenience, and digital engagement.

As Deloitte recently noted, Generative AI (artificial intelligence)—which can create various forms of text, media, and data—has the potential to make health care more user-friendly, efficient, and expedient by responding to patients after hours, providing faster insurance coverage and authorization, and recommending clinicians based on their health profile.[9] Digital transformations, such as virtual health, offer increased access, enhanced convenience, and lower costs for patients, while more "back-end" investments like cloud and advanced data analytics can result in better patient-facing products such as a health system EHR app (e.g., MyChart). Investments in population health, including network design, medical practice transformations, data analytics, and clinical operations, offer to improve quality and lower costs for patients by focusing on end-to-end care. According to the World Economic Forum, "it's increasingly likely that advances in medical technology will improve the chances of a successful outcome."[10]

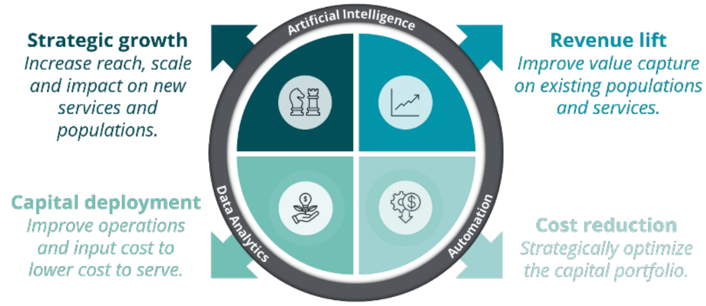
Lastly, the continued shift of clinical care to alternative sites of care greatly enables patient convenience, cost, and access, all while alleviating burgeoning health system capital expenditures. Investment costs vary based on the site of care, ranging from $1.4 million per ambulatory surgery center operating room and $7 million to $30 million for a micro-hospital,[11] while the savings are notable with hospital-at-home programs reducing costs by 25% compared to traditional inpatient stays.[12]

Large investments in data, technology infrastructure, consumer and clinician apps, new sites of care and modalities, training, and process improvements are typically required to successfully adopt these innovations.

How can health systems enhance margin?

Reducing costs has long been the go-to approach for improving margin, as well as focus on revenue, capital deployment, and strategic growth. However, these efforts and results are often fragmented or not properly aligned and harmonized for value. What should be considered, rather, is a holistic approach to margin improvement that integrates margin drivers, including strategic growth (reach and scale of existing or new services), revenue enhancement (capturing more value from existing services), and capital deployment (optimizing the capital, including asset portfolio) to create a balanced transformation portfolio. Within each driver, the timing and sequencing are crucial, and a full understanding of the dollar impact and priority of each is necessary for margin improvement to be successful. Finally, no transformation can be effective without considering a holistic human and workforce transformation to support.

Deloitte's strategic margin transformation framework



Conclusion

Health system margins are the lifeblood of a healthy, patient-centered, innovative health care system and community. Claims that profits are not important in fact undermine the ability to fund the mission, serve the community, and deliver better, equitable care. Health system board members, executives, community leaders, and policymakers should focus first and foremost on their fiduciary responsibility to supporting a viable and innovative health care system over the long term.

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