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David Jones' Locker:

Humana and the Perils of Vertical Integration

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By David Johnson, CEO

American healthcare is losing the iconic Humana brand. Aetna has announced it will acquire Humana for $37 billion in cash and stock. The combined company will become the nation's second largest health insurer behind United Healthcare.

Somewhere in Louisville, Humana's legendary founderDavid Jones is smiling. Humana began as a single nursing home in 1961. Along the way, the company became the nation's largest hospital chain, embraced health insurance, struggled with vertical integration and jettisoned its hospitals.

More recently, Humana has become an industry leader in care management, care transitions and home-based care. These attributes make Humana valuable to Aetna.

Humana's turbulent history provides strategic insights for health companies repositioning for post-reform success.

Before Humana fades into obscurity, let's peak into David Jones' Locker and see what secrets it reveals.

In the Beginning

As young lawyers, David Jones and Wendell Cherry started a nursing home company on the advice of one of their real estate clients. Each invested $1000. Their first facility opened in 1962 on Liverpool Lane in Louisville.

They named their company Extendicare in 1968. By the early 1970s, Jones and Cherry were operating the country's largest long-term care company. In 1972, they sold their nursing homes and set their sights on hospitals.

Extendicare applied large-scale management practices to hospital management as demand for hospitals exploded. Extendicare became Humana in 1974. Within a decade, Humana was the nation's largest hospital company.

The Allure of Integrated Delivery

First with Extendicare and then Humana, Jones used horizontal integration and the economies of scale to build efficient, nationwide delivery platforms.

Humana's movement into health insurance was almost accidental. An Arizona hospital lost a regional HMO contract. Hospitals need patients to survive. Humana responded by creating a health insurance plan in Arizona to channel patients to its hospital.

Like General Motors, IBM and Pepsi before it, Humana decided it could become more profitable by owning its suppliers. Aligning all elements of a company's supply chain is the essence of vertical integration. While simple in concept, executing vertical integration is hard. It fails more than it succeeds.

Humana's vision was elegant. The company offered low-cost health insurance to expand market presence and increase patient volume for its efficient hospital network.

Health plan subscribers using in-network facilities and physicians avoided co-pays and deductibles. Humana also built primary care centers with salaried physicians to steer specialty-care volume to in-network providers.

However, Humana encountered significant challenges pursuing integrated delivery:

- The health plan sent subscribers to lower-cost, out-of-network providers;
- Primary care physicians competing with Humana's primary care centers did not refer patients to Humana's hospitals;
- Competing health plans reduced referrals to Humana's hospitals;
- Hospital occupancy declined;
- As its insured physician network expanded, Humana's delivery efficiency declined;
- Employed-physician productivity declined;
- Hospital costs spiked; and
- Employee moral within Humana's hospitals plummeted.

Jones admitted defeat. Humana spun off its hospitals and sold its primary care centers. By 1994, the once-proud hospital company was now exclusively a health insurance provider.

Diseconomies of Complexity

Humana's hospitals sunk to "the bottom of the ocean." Strategists see vertical integration's beauty, but underestimate its complexity.

Like Davy Jones in Pirates of the Caribbean, vertical integration's "devils" emerge from the "deep blue sea" of operations. They confound senior executives with turmoil.

Vertical integration creates several potential sources of conflict and energy drain:

- Culture clashes: Operators and suppliers see the world differently. They aren't inclined to solve one another's problems;
- Embedded problems don't disappear: Vertical integration cannot "create" demand for faltering businesses. Customers gravitate to lower-cost, higher-value products and services;
- Mushy transfer pricing: Absent real market competition, internal service pricing and cost allocations become political exercises;
- Favoritism for internal suppliers: Operators cannot seek higher-value external alternatives;
- Too much refereeing: Disputes between operating divisions expand and intensify. Senior managers expend too much energy resolving disputes. "Solutions" are often sub-optimal; and
- Lost focus: Companies lose competitive advantage. Diseconomies of complexity overwhelm the benefits of vertically-integrated operations

Back to the 1990s: Provider-Sponsored Health Plans Rise Again

On June 8th, Standard & Poor's issued an in-depth, measured and largely positive report on provider-sponsored health plans (PSHPs). Their report highlights the following:

- *The development of provider-sponsored health plans benefits from incentives under health reform and the Affordable Care Act.*
- *Ownership of PSHPs contributes to providers' geographic and financial dispersion and can provide hospitals and health systems with access to skills and data we consider critical as health care reform evolves toward population health management.*
- *Credit and rating impacts from the development of PSHPs have been minimal to date.[3]*

Many health systems report frustration with payors' unwillingness to share risk. They complain payors disproportionately benefit from their cost-cutting and utilization improvement. In response, many providers are developing/expanding health plans and moving toward pluralistic delivery models.

The S&P report analyzes sixteen health systems with PSHPs. In aggregate, these PSHPs collect $25 billion in premium revenue and cover seven million individuals. S&P's list is far from comprehensive and does not include many large systems (e.g. CHI, Dignity, Sutter) who are launching health insurance plans.

While S&P highlights the benefits of PSHPs in expanding health systems' market presence and care management capabilities, they acknowledge that vertical integration increases operating volatility. They also note that internal transfer pricing "is generally opaque to outside parties monitoring company performance."[4]

Credit ratings are a function of overall system performance. On balance, S&P believes "the added geographic dispersion and opportunities for further revenue dispersion and delivery system growth are strengths, assuming operations are profitable"[5] (italics added).

The healthcare marketplace is remarkably dynamic. As providers build insurance capabilities, payors are making investments in care delivery. Competitive differences between providers and payors are blurring.

As the U.S. health migrates to consumerism and value-based care, expect market-to-market combat between providers, payors, combinations and new entrants to capture expanding demand for care management services.

Is This Time Different?

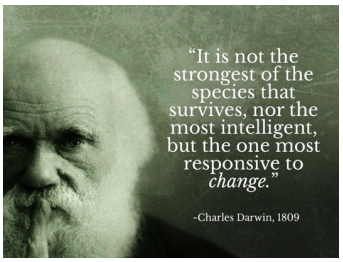
As Yogi Berra said, "It's déjà vu all over again." In the 1990s, health systems invested heavily in health plans. The rational then was the same then as it is today, "gaining more and earlier access to the premium dollar."[6]

Health systems assert they've learned the "hard lessons" of the late 1990s when "many entered and exited the PSHP business often with sizable and embarrassing losses."[7]

While data systems are better and integrated delivery knowledge is greater, there is excess acute capacity in most markets. While changing, hospital business models still emphasize volume and activity-based payment. Adding a health plan will not solve health systems' "excess supply" problem.

Moreover, vertically-integrated business models contain inherent and often overwhelming complexity. Transfer pricing, culture clashes, dispute resolution and lost focus are compelling obstacles to organizational success.

Here's Market Corner's prediction. Some health systems will succeed at pluralistic delivery, but most will struggle and some will fail. Expect high performance variation as companies gain experience with new payment models and changing customer needs.



Charles Darwin observed, "It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most responsive to change."

What is true in nature is also true in markets. Winning health companies adapt business models to meet customer demands by delivering better care at lower prices