Brand-Heavy and Asset-Light:
Moving Beyond the Acute-Care Mindset

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Market Corner Commentary
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For health systems, the day of reckoning is near. A recent Morgan Stanley report states that over 1,000 of the nation's 5,000+ hospitals are currently weak or at risk of closing.[1] This is the beginning of a larger wave.

The pressure is top down and bottom up. Payers are unwilling to continue unadulterated fee-for-service (FFS) payment formularies. Consumers increasingly expect convenience, lower costs, better outcomes and improved customer experience.

Traditional hospital-based care delivery is a high-cost, low-margin, capital- and labor-intensive endeavor. The operating model is asset heavy, highly fragmented, intensely regulated, error-prone and inefficient.

Innovative and non-traditional competitors see these systemic inefficiencies and the growing demand for services as a massive opportunity. They're well-funded and moving fast on multiple fronts, giving consumers appealing options with convenient, low-cost care sites and tech-enabled services.

Multiple other industries, including retail, hospitality, transportation and aviation, have experienced this disruptive transition. By moving away from asset-heavy business models, platforming their operations and prioritizing outcomes and service, they reduce friction, lower costs and improve customer experience.

In like manner, enlightened health systems will shift from capital-focused business models that value facility ownership, revenue optimization, days of cash-on-hand, and bond ratings, to operations-focused business models that prioritize cash flow, margins, customer service and performance.

These health systems will be asset light and brand heavy. They will scale and grow market share by covering more lives, influencing physicians and caregivers, distributing care and controlling costs, not by investing more capital in high-cost acute facilities.

The transition will not be easy or painless. There will be clear winners and losers. Success requires cultural transformation and tough resource allocation decisions. It also demands new and innovative approaches to capital formation.

ADAPTING TO REALITY

Despite the market shift toward distributive and tech-enabled care delivery, health systems continue to devote substantial capital to constructing and upgrading costly facilities.[2] Between December 2017 and January 2018, 12 health systems announced capital projects of more than $300 million each.[3] In May, seven other health systems followed suit.[4]

A number of these capital programs exceed $1 billion. Generating a return on these massive capital investments requires increasing volume and/or ever-higher reimbursement payments. These asset-heavy investments are fighting against an inevitable shift in business model. There are less capital-intensive and more customer-focused ways to expand.

To imagine how hospital facilities might evolve differently, consider the trajectory of retail shopping. Challenged initially by low-cost megastores like Walmart and later by Amazon, shopping malls began to hollow out as conventional retail stores closed, and department stores eliminated underperforming locations and consolidated.

The survivors are now changing their operating models, many becoming a "cross between a fast-food drive through and a hotel concierge."[5] Apparel stores are shifting from inventory-heavy physical locations to become centers that coordinate online distribution and non-traditional channels while offering new services.[6] Nordstrom's, for example, now operates stores with smaller footprints that function as pick-up locations for goods purchased online while also providing boutique services like fitting and tailoring.[7] Walmart employs 25,000 personal shoppers to prepare orders for curbside pickup.

Competitive retail facilities rely on premium locations and focus on service, experience and entertainment. Stores lease rather than own facilities. REIT's continue to invest in the sector but do so with a strategic understanding of how evolving customer needs can be met through physical locations in a market dominated by e-commerce.[8] Forward-thinking REITs are doing the same in the healthcare space.

A growing number of healthcare organizations now believe a similar focus on service, experience and convenience can best be operationalized through vertically integrated and performance-driven operations. Such entities:

- Create a seamless customer experience;
- Operate on a platform that integrates services, functions and capabilities;
- Rely on highly sophisticated supply-chain logistics;
- Coordinate distributed operations across multiple sites and channels;
- Develop deep data liquidity and aligned technologies to improve service and performance;
- Implement robust cost accounting; and
- Embrace risk-based payment models, particularly those that encompass full-risk contracting.

ALTERNATIVE DELIVERY CHANNELS

To meet customer expectations and needs in a more market-driven environment, innovative health companies are expanding and deepening patient interactions through a variety of convenient, lower-cost channels.

Virtual Care

Patients like the convenience and ease of virtual consultation and increasingly show willingness to pay out-of-pocket for non-covered services.

Integrated virtual health solutions can help health systems avoid readmissions, attract new patients and coordinate care. The reach and scale of such solutions is growing. Kaiser Permanente, for example, offers services to its 30 million enrollees through online portals, virtual visits or applications.[9] Teladoc, the world's largest virtual care company, doubled its number of provider partnerships in 2017.[10]

While Medicare does not typically cover virtual visits, proposed CMS rules will expand virtual care access to Medicare Advantage customers through private plans. Projecting growth in virtual services, Cigna and Health Care Service Corporation (parent of 5 Blue Cross/Blue Shield plans) made a $50 million strategic investment in telemedicine company MDLive in August 2018.

Micro-Hospitals

Also known as neighborhood hospitals, micro-hospitals operate 24/7 to deliver care in convenient locations at a fraction of the size, capacity and cost of regular hospitals.

Patients like the convenience, access and personalized service. For health systems, these alternative sites reduce overhead, expand customer reach, deepen community ties and execute on a distributed care-delivery strategy.[11]

Proposed regulatory changes complicate reimbursement for services delivered at micro-hospitals, precisely because these facilities erode market share from higher-cost acute care hospitals. Yet, micro-hospitals can be vital lower-cost, convenient components of more distributed, customer-focused delivery networks.[12]

Retail Clinics

CVS and Walmart, two aggressive competitors with deep customer knowledge and retail expertise, now reach patients through nationwide networks of convenient alternative care sites. As these companies further integrate or partner with payers and PBMs, their ability to provide commodity care services will only grow.

As market forces intensify, new services and alternative channels will proliferate on multiple fronts. Large employers like Apple, for example, are launching work-site clinics to offer care services to employees. The new care company formed by Amazon / Berkshire Hathaway / JP Morgan Chase intends to optimize care delivery for their covered lives with tech solutions that enhance ease, transparency, access and choice. Other institutional consumers will follow suit.

Even retailers like Best Buy are getting into healthcare. In their largest acquisition ever, Best Buy acquired safety and solutions company GreatCall in July 2018 for $800 million.[13] Picture consumer-focused care delivery with the convenience and service of Best Buy's famed Geek Squad. (Read a 4sight Health Market Corner Commentary about Best Buy's acquisition of GreatCall here.)

SCALING TOWARD VALUE

Today, innovative providers grow by engaging physicians, covering more lives and expanding services while increasing access and tightly controlling costs. They reject conventional priorities like facility ownership and revenue optimization in favor of customer value, brand strength and enhanced experience.

DuPage Medical Group
WE CARE FOR YOU

DuPage Medical Group

Beginning in late 2015, when it sold a minority stake to private equity firm Summit Partners, Chicago-based DuPage Medical Group (DMG) undertook a strategy of expansion by acquiring local physician practices. The company's Management Services Organization (MSO) equips new physician groups to work within DMG's vertically-integrated platform that accommodates full-risk contracting.

A massive capital infusion earlier this year from Ares Capital[14] fuels DMG's ongoing growth through physician practice acquisitions, expansion into new geographies and entry into new, complementary service lines, like physical therapy. This aggressive growth strategy has turned DMG into a strong regional competitor, operating convenient, efficient facilities that offer high-quality service.

One Medical

one medical

In 2007, two years after launching a solo primary care practice in San Francisco, One Medical secured venture funding from Benchmark Capital. One Medical's convenient, personalized and tech-enabled business model attracts young, healthy patients who pay an annual membership fee of $199 or receive it as a benefit directly from their employers.

One Medical's clinics resemble boutique hotels with virtual scheduling, no waiting and last-minute appointment availability. Care delivery combines high-touch service with high-tech tools and applications. Members can access care through 24/7 phone support, virtual services and mobile apps that include health coaching. Patients can email their doctors with follow-up questions. OneMedical's agile technology and data platforms keep administrative costs low.

In late August 2018, the Carlyle Group invested $350 million in growth capital to fund One Medical's expansion into both new and existing markets through new clinics, new services and physician acquisition.[15]

Steward
World class health care where you live.

Steward Health Care

Steward Health Care System formed as a for-profit company in 2010 when Cerberus Capital Management acquired Boston-based Caritas Christi Health Care system. In a landmark 2016 transaction, Steward sold its 9 hospital facilities and a small equity stake to the Birmingham, Alabama REIT Medical Properties Trust (MPT) for $1.2 billion. Subsequently, MPT served as Steward's capital partner in acquiring 8 CHS hospitals and Iasis. Steward now operates in 10 states.

Steward has invested heavily in multiple physician practice models, risk-based contracting capabilities, systems optimization (e.g. projected staffing levels) and consumer-friendly technology. Steward offers acute and non-acute services through facilities and delivery channels it controls. It strives to be the lowest-priced, community-based provider of high-quality care services in its markets.

Today, Steward is the largest private, for-profit hospital operator in the U.S. By emphasizing brand strength and customer experience, Steward's operating model resembles the asset-light approach favored by major hospitality companies, including Marriot, Hyatt and Hilton. Steward demonstrates that success depends more on price and outcomes than facility ownership and control.

Optum

UnitedHealth Group's Optum has grown rapidly through vertical integration. Its delivery platform includes over 200 MedExpress urgent-care and walk-in centers with 30,000 clinicians serving more 15 million people across the US. Through its 2017 acquisition of Surgical Care Affiliates, Optum added 200 outpatient surgery centers.

The 2017 acquisition of DaVita Medical Group incorporated 6 more surgery centers, 300 clinics and 1.7 million additional patients into its expansive care network.[16] Significantly, Optum has chosen not to acquire high-cost acute care hospitals.

Optum's ecosystem of patient services is not facility-dependent. Its strategy is to "transform the healthcare provider space into a digital experience" by integrating its services with sophisticated technologies, data analytics and clinical insights that improve care quality and system performance.[17]

Atrius

Atrius is a large multispecialty physician group in the Boston suburbs, comprised of hundreds of physicians, thousands of covered lives, and dozens of ambulatory care locations. They are a health system without the burden of owning hospitals. Focusing on high-quality, coordinated care, Atrius built on an integrated IT platform and established the capacity to take top-line risk. They are intentionally positioning for the future of American health care.

Though their approaches vary, these companies prioritize operational performance. Fueled by internal cashflow and external funding, they grow by acquiring physicians and expanding their asset-light platforms to cover more lives with more services.

RETHINKING CAPITAL FORMATION FOR NOT-FOR-PROFIT (NFP) HEALTH SYSTEMS

Competing against asset-light companies like Optum, Steward, DMG, One Medical and Atrius can be daunting for not-for-profit (NFP) health systems. Few have sufficient capital access to fund development of asset-light operating platforms.

Necessity is the mother of invention. There are several alternative pathways NFP systems can consider.

By forming for-profit MSOs, NFP health systems can provide the convening and capital infusion role typically offered by private equity companies. The MSO can offer equity stakes to aligned physicians to create funding vehicles for network expansion. This also enhances the "stickiness" of physician relationships without actually acquiring the physician practices.

NFPs can also monetize hospitals through asset sales to REITs or other real estate purchasing entities. This generates a substantial cash payment and shifts long-term facility ownership risks to the facility buyer.

Other NFP systems see strategic partnerships as a way to bring in capital, new capabilities and operating expertise. For example, NFP health systems can partner with payers to offer full-risk contracts directly to public and private employers.

Post-reform healthcare is a new game with new rules. Winning companies will differentiate by focusing on outcomes, building brand strength, optimizing capital investment, running lean and prioritizing customer experience. This requires dismantling the acute care managerial mindset and replacing it with a disruptive, consumer-driven, performance-oriented, managerial mindset.

EVOLVING TO THRIVE IN A NEW MARKET

In a presentation to the Accountable Care Learning Collaborative on August 27th, 2018, CMS Administrator Seema Verma emphasized that CMS would grant greater financial benefit and regulatory flexibility to providers willing to accept "downside" risk for the care they deliver.

In a world of convenient, low-cost alternative care sites and tech-enabled care delivery services, customers will increasingly avoid hospitals and affiliated clinics when seeking care. Instead, they will turn to care providers that meet their demands for convenience, connection and cost.

Revenue-cycle optimization and facility ownership are relics of an era that is passing quickly. In the near future, the best health organizations will distinguish themselves as companies in all other markets do.

They will be well-funded and financially flexible rather than debt-laden with high operating and overhead costs. They will be administratively efficient and disciplined. They will manage costs to drive profitability. Their physicians will be incented, aligned and committed to organizational priorities.

If they deliver on their promise of great service, quality outcomes and convenience, then customers will seek them out.

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