Minnesota Hospital Association

MHA Issue Brief: The Financial Health of Minnesota Hospitals and Health Systems in Fiscal Year 2015

March 2017

Introduction

Minnesota's hospitals and health systems have earned a national reputation for delivering safe, high-quality care and for meeting the needs of their communities by providing medical services across the continuum of care. Nearly all hospitals in Minnesota are operated as either private, not-for-profit or government-owned facilities. There are two for-profit specialty hospitals operating in Minnesota.

While many financial indicators are relevant to a thorough analysis of financial health, a hospital's operating margin is the most recognizable bottom-line measure of whether a hospital can continue to meet patient and community needs. This is the first report that the Minnesota Hospital Association (MHA) has issued on behalf of its members related to members' financial health. This report includes publicly available information that hospitals and health systems are required to submit to the Minnesota Department of Health annually.

Statewide trend

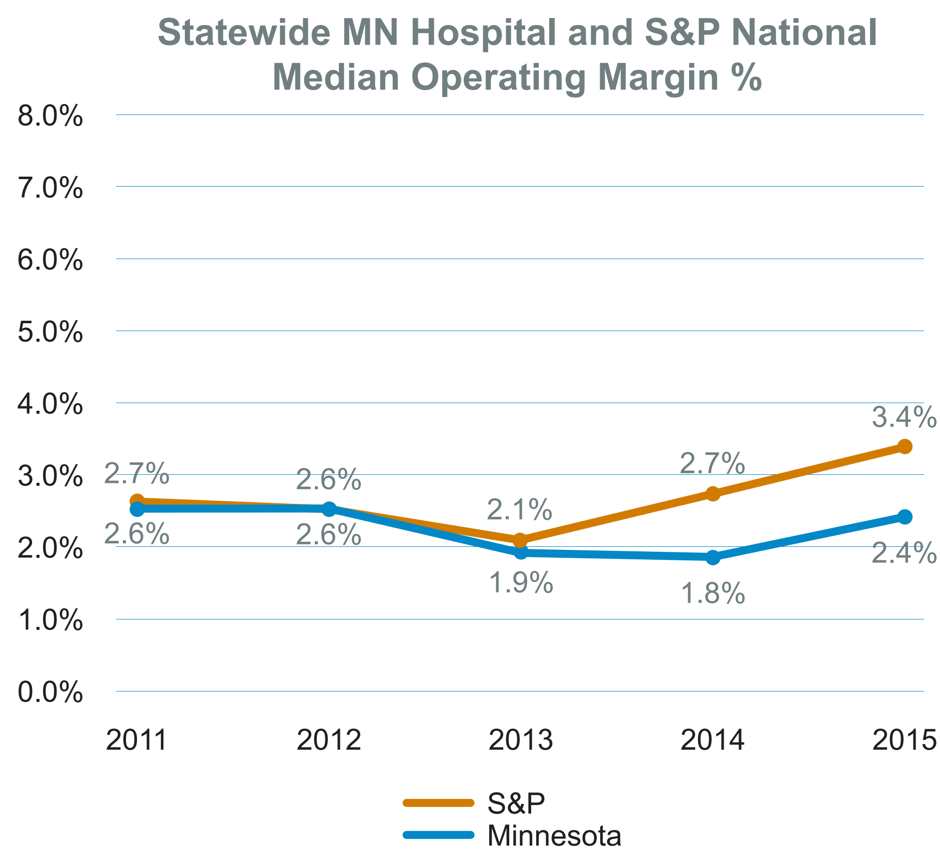
The trend of median hospital operating margin has remained steady at approximately 2.5 percent since 2011. While there is no specific benchmark operating margin established for the not-for-profit hospital market, a 5 percent operating margin is considered by health care economists as a healthy baseline. Numerous data companies, consultants, lending institutions and credit ratings agencies produce financial comparison data targeted for hospitals. To identify a credible source of national comparison data, MHA contacted Piper Jaffray, an investment bank with expertise in health care. Piper Jaffray advised that Standard & Poor's (S&P) would be an appropriate source for national comparison data. The S&P benchmarks are included in the margin graphics shown in this report.

Steve Proeschel, head of health care finance at Piper Jaffray, provided the following background information on the use of hospital margins data: "A hospital's ability to access the capital markets is dependent, amongst other things, on an ability to demonstrate a consistent history of strong earnings from operations. Failure to do so can limit ability to borrow or greatly increase capital costs. Ultimately, this can lead to a downward spiral in which hospital facilities cannot be maintained or reinvested in, resulting in further declines in revenue and profitability. Investors look at operating margin as a leading indicator of fiscal health and long-term viability."

Hospitals are capital-intensive organizations. In emergency and life-sustaining situations, patients need access to high-tech diagnostic imaging, laboratory equipment, pharmaceuticals, scopes and scanners – along with highly skilled medical providers – to achieve the best outcomes. Much of the technology and equipment utilized by hospitals is subject to constant upgrade needs in line with technological advancements. At the same time, models of care are ever-improving, migrating from inpatient to outpatient settings as facilities, equipment and medical techniques evolve. These dynamic changes often require long-term capital investments to meet the needs of the community. Without a positive operating margin, hospitals have limited financial flexibility to make necessary facility improvements.

While the majority of Minnesota's hospitals experienced a positive operating margin in 2015, MHA noted that 38 hospitals, or 29 percent of hospitals statewide, had negative operating margins. The vast majority of these hospitals were in rural areas. Twenty-one independent hospitals shown in this report had negative operating margins in 2015, while another 17 hospitals with a negative operating margin were associated with systems and therefore are included in the overall system totals.

Below is a comparison of Minnesota hospitals' statewide median operating margin compared with a national sample from S&P.



Source: MHA's statewide audited financial statements medians including stand-alone hospitals and Healthcare systems.

S&P not-for-profit acute healthcare medians national comparison including stand-alone hospitals and health care systems.

Sample sizes for S&P data: 2011: 551, 2012: 517, 2013: 501, 2014: 476, 2015: 436

S&P data provided courtesy of PiperJaffray

How to read this report

The operating margin is a measure of revenues compared with expenses related to hospital patient care services. The net margin measure further adds revenues and expenses related to non-patient care services such as donations, investment income or losses and gains or losses from the disposal of assets. This report primarily focuses on operating margin, since it is the most relevant measure of patient care services and factors under the control of hospital management.

As not-for-profit organizations, hospitals have a fiduciary responsibility to reinvest their margins into services that enhance the ongoing viability of their facilities and service offerings. In addition, hospitals are often integrated with other non-hospital medical services such as clinics, nursing homes, ambulance services, home health care and hospice services to meet community needs. In many cases, the hospital's margin is utilized to cross-subsidize some of these non-hospital services, often operated with low or negative margins, to support the community's need to have access to these services.

Unlike for-profit proprietary or corporate hospitals, not-for-profit hospitals do not have a profit motive to maximize stockholder income. Net revenues over expenses at not-for-profit or government-owned hospitals are reinvested back into the facilities to support community access to high-quality medical services.

MHA, in conformance with many national sources, utilizes the median value of margins to track these indicators of hospitals' financial health. The median figure represents the statistical middle value, whereby 50 percent of hospitals are above and 50 percent are below this amount. Using the median value eliminates some of the bias that an average can have with greater weight being given to larger facilities.

Factors that influence margin

A hospital's mix of payer sources can have a significant impact on its ability to achieve a manageable operating margin. Factors such as higher poverty rates with more uninsured or underinsured patients; a high government payer mix of Medicare and Medicaid; or significant investment in low-margin, non-hospital medical services such as nursing homes and home health agencies can influence a hospital's ability to achieve an adequate operating margin.

The increasing adoption of high-deductible health plans, which place a greater financial responsibility on patients, is another factor now influencing revenues. In some cases, patients are unable to pay the deductible amounts they owe. Uncompensated care costs, in the form of charity care write-offs and bad debt expense, can impact a hospital's ability to achieve a positive operating margin.

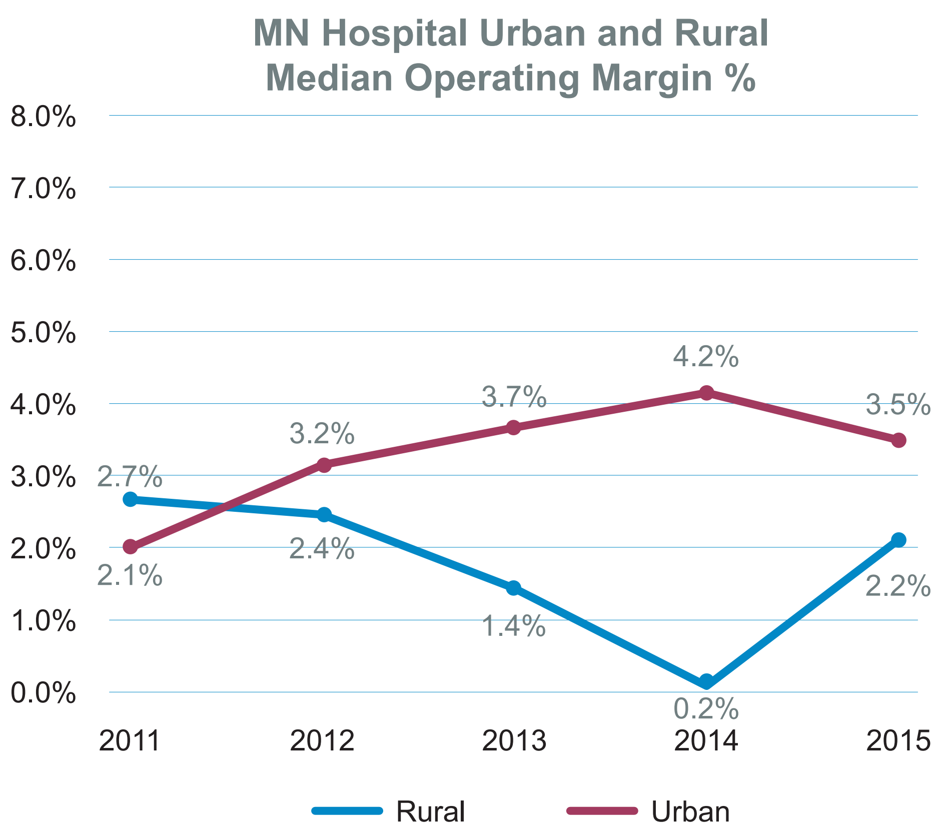
On the expense side, hospitals are heavily reliant on wages and benefits to meet patients' needs. Labor-related expenses represent approximately 52 percent of hospitals' cost structure. Hospitals employ highly skilled and experienced medical professionals who tend to earn correspondingly higher wage rates, such as physicians, nurses, pharmacists and advanced practice health care professionals. In many cases, workforce shortages in key clinical areas further increase compensation costs.

Buildings and capital equipment generally represent just under 6 percent of the average hospital's cost structure. Remaining costs include supplies, utilities and other related operating costs. Hospitals are affected when market forces increase supply costs, such as the increasing cost of pharmaceuticals.

Urban and rural differences

Minnesota has 34 urban hospitals and 111 rural hospitals, including 78 critical access hospitals that have 25 or fewer beds. Urban hospitals tend to experience higher margins than rural hospitals, which are typically smaller facilities serving communities that generally have older populations and, on average, lower wage rates. This leads to a higher payer mix based on government-sponsored health care offerings of Medicare and Medicaid. Medicare and Medicaid payments usually reimburse hospitals at or below the cost of care, on average. Hospitals often must rely on commercial reimbursement to cover the costs of Medicare and Medicaid underfunding.

From 2012-14, urban and rural hospitals saw a divergent trend in operating margins, with margins increasing at urban hospitals and decreasing at rural hospitals. However, the opposite held true in 2015; operating margins decreased at urban hospitals and increased at rural hospitals. Rural hospitals were able to improve their margin in 2015 by focusing on growth in outpatient services and improved revenue collections. As health care market conditions evolve, MHA will continue to monitor whether reform impacts differ between urban and rural hospitals.

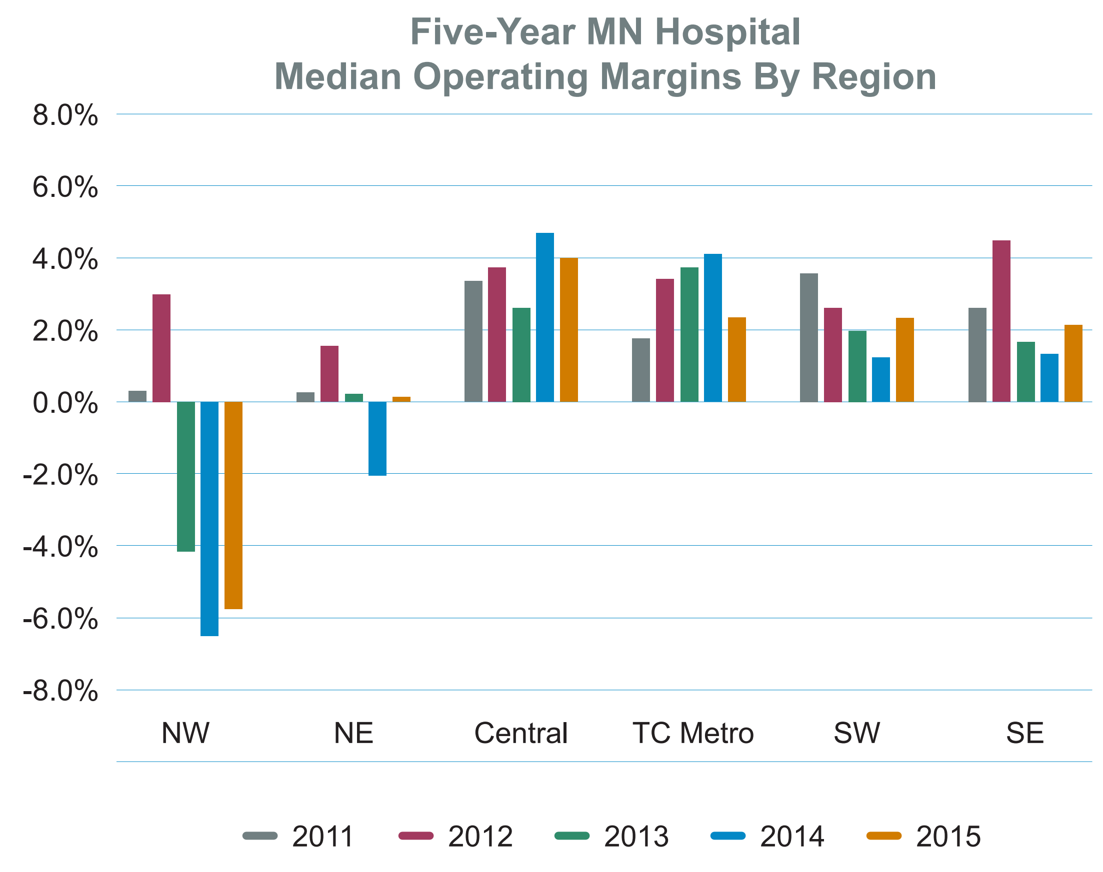


Source: MHA's statewide audited financial statements medians including stand-alone hospitals and Healthcare systems.

Operating margins by region

Much of the variation in operating margins among geographic regions of the state relates to hospital size and regional population mix. Rural hospitals tend to experience lower margins, on average, due to the size and scope of their service offerings. Rural hospitals are also more often cross-subsidizing other non-hospital services to provide community access to services that create a continuum of care, such as nursing homes, ambulance services, free-standing clinics, home health care and others.

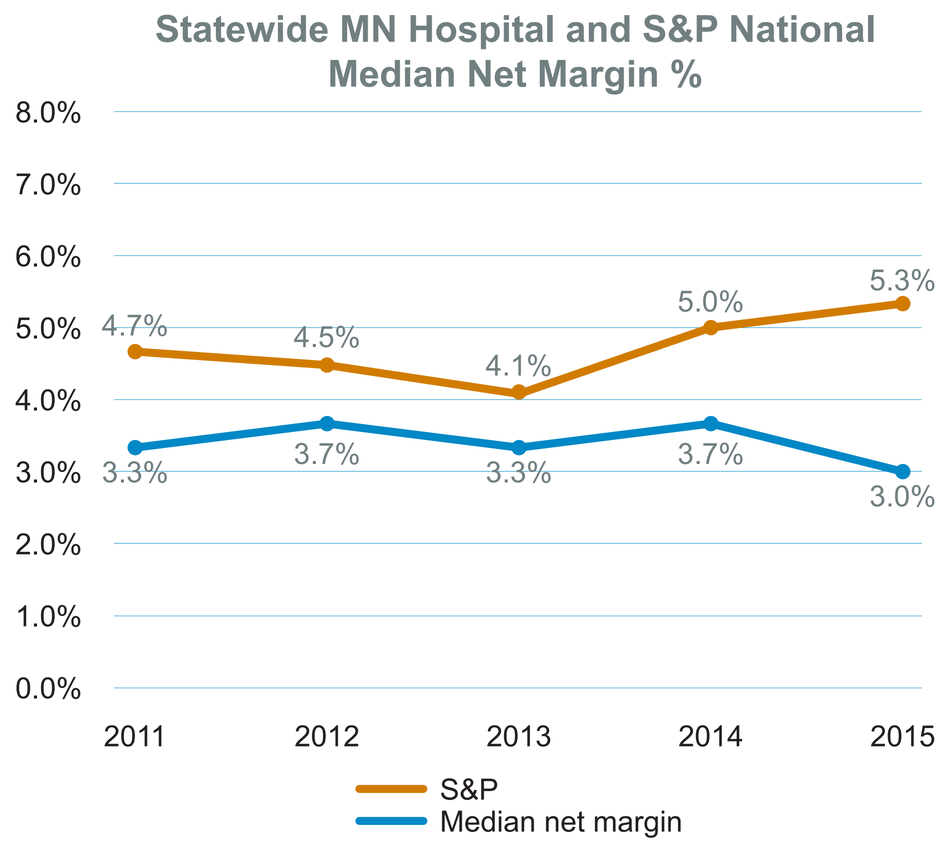
From 2011-15, hospitals in the northern regions of Minnesota – where the population density is lower and there are fewer hospitals – had predominantly lower and negative operating margins.



Source: MHA's statewide audited financial statements medians including stand-alone hospitals and Healthcare systems.

Net margin trend

As mentioned previously, the net margin reflects the overall financial impact of revenues over expenses during the fiscal year reporting period. It is comprised of both operating and non-operating revenues over expenses, including donations, investments and disposal of assets, for example. In positive market conditions, the net margin typically tracks close to and slightly more positive than the operating margin. The trend has been fairly stable; however, this margin is tending to track lower than the national median, as reflected by S&P.



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S&P data provided courtesy of PiperJaffray

Hospital and health system margins

The chart below depicts both the operating margin and net margin dollars and percentages for each of Minnesota's hospitals and health systems. Detailed information about individual hospitals that are owned by health systems is not available because this type of information is generally not presented in audited financial statements. The figures are based on the fiscal year-end operating period that ended in 2015.

Hospital	FY15 Operating Margin Dollars	Operating Margin %	FY15 Net Margin Dollars	Net Margin %
Allina Health	$ 149,021,000	3.9%	$ 130,521,000	3.4%
Appleton Municipal Hospital and Nursing Home	$ (429,659)	-3.7%	$ (309,246)	-2.7%
Avera Marshall Regional Medical Center	$ 1,977,500	2.8%	$ 2,099,508	2.9%
Avera Tyler	$ (1,259,010)	-10.6%	$ (1,176,991)	-9.8%
Bigfork Valley Hospital	$ (562,044)	-2.5%	$ (28,363)	-0.1%
Catholic Health Initiatives	$ 3,113,000	0.0%	$ 109,462,000	0.7%
CentraCare Health	$ 63,249,203	5.6%	$ 60,479,946	5.3%
Children's Hospitals and Clinics	$ 48,876,000	5.9%	$ 40,274,000	4.7%
Chippewa County-Montevideo Hospital	$ 61,971	0.2%	$ 340,735	0.9%
Community Memorial Hospital	$ 1,073,189	2.2%	$ 1,436,088	2.9%
Cook Hospital & C&NC	$ (651,255)	-5.2%	$ 641,041	4.6%
Cuyuna Regional Medical Center	$ 3,026,193	2.9%	$ 3,516,305	3.4%
Douglas County Hospital	$ 8,850,976	6.3%	$ 9,650,155	6.8%
Ely-Bloomenson Community Hospital	$ 248,073	1.5%	$ 622,900	3.7%
Essentia Health	$ 65,338,000	3.5%	$ 82,286,000	4.3%
Fairview Health Services	$ 140,130,000	3.6%	$ 71,270,000	1.8%
FirstLight Health System	$ 5,103,041	7.6%	$ 5,269,412	7.9%
Gillette Children's Specialty Healthcare	$ 9,332,510	4.0%	$ 7,134,216	3.0%
Glacial Ridge Health System	$ 1,627,912	5.5%	$ 1,992,351	6.6%
Glencoe Regional Health Services	$ 2,464,245	4.5%	$ 3,298,691	6.0%
Grand Itasca Clinic and Hospital	$ (8,435,205)	-11.2%	$ (8,087,556)	-10.7%
Granite Falls Municipal Hospital & Manor	$ 1,139,381	5.6%	$ 1,139,381	5.6%
HealthEast Care System	$ 17,124,000	1.8%	$ 21,230,000	2.2%
HealthPartners, Inc.	$ 103,480,000	1.8%	$ 103,480,000	1.8%
Hendricks Community Hospital Association	$ 320,892	2.4%	$ 316,249	2.4%
Hennepin Healthcare System, Inc.	$ 8,463,000	1.0%	$ 20,724,000	2.3%
Hutchinson Health	$ (2,153,054)	-2.3%	$ (2,421,726)	-2.5%
Johnson Memorial Health Services	$ 985,942	6.1%	$ 1,444,336	8.7%
Kittson Memorial Healthcare Center	$ (1,634,916)	-13.3%	$ (176,652)	-1.3%
Lake Region Healthcare Corporation	$ 2,957,012	2.4%	$ 4,663,712	3.8%
Lake View Memorial Hospital	$ 940,236	6.4%	$ 734,024	4.9%
Lakewood Health System	$ 2,774,148	2.9%	$ 2,865,433	3.0%
LifeCare Medical Center	$ 1,998,369	4.9%	$ 2,219,739	5.4%
Madelia Community Hospital, Inc.	$ (485,254)	-4.7%	$ (230,895)	-2.2%
Madison Hospital	$ (987,277)	-6.7%	$ (235,599)	-1.5%
Mahnomen Health Center	$ (934,136)	-11.6%	$ (397,878)	-4.6%
Mayo Clinic	$ 534,000,000	5.2%	$ 389,000,000	3.8%
Meeker Memorial Hospital	$ 2,595,349	8.1%	$ 2,997,347	9.3%
Mercy Hospital	$ (606,720)	-1.9%	$ (69,356)	-0.2%
Mille Lacs Health System	$ (210,677)	-0.6%	$ (140,238)	-0.4%

Hospital	FY15 Operating Margin Dollars	Operating Margin %	FY15 Net Margin Dollars	Net Margin %
Minnesota Valley Health Center	$ (476,699)	-4.3%	$ (433,340)	-3.9%
Murray County Memorial Hospital	$ (719,467)	-4.5%	$ (576,758)	-3.6%
North Memorial Health Care	$ 15,433,812	1.8%	$ 8,613,361	1.0%
North Shore Health	$ (928,371)	-6.9%	$ (40,979)	-0.3%
North Valley Health Center	$ (1,042,139)	-11.4%	$ (1,008,253)	-11.0%
Northfield Hospital	$ 2,723,828	3.0%	$ 3,485,961	3.8%
Olmsted Medical Center	$ 13,502,188	7.3%	$ 14,319,945	7.7%
Ortonville Area Health Services	$ 616,187	2.3%	$ 785,459	2.9%
Perham Health	$ 542,131	1.2%	$ 1,540,773	3.2%
Pipestone County Medical Center	$ (926,186)	-3.5%	$ 256,973	0.9%
Prairie Ridge Hospital & Health Services	$ (423,181)	-3.0%	$ (314,754)	-2.2%
Rainy Lake Medical Center	$ (233,615)	-1.0%	$ (203,412)	-0.9%
RC Hospital	$ 894,519	3.8%	$ 664,277	2.8%
Redwood Area Hospital	$ 1,880,767	7.5%	$ 1,922,726	7.5%
Regency Hospital of Minneapolis	$ 4,342,119	10.7%	$ 2,927,661	7.1%
Rice Memorial Hospital	$ 2,448,140	2.5%	$ 3,462,762	3.4%
Ridgeview Medical Center	$ 2,400,386	1.0%	$ 9,254,934	3.9%
River's Edge Hospital & Clinic	$ 655,021	2.4%	$ 776,129	2.9%
Riverview Healthcare Association	$ 3,746,421	7.2%	$ 3,802,225	7.3%
Riverwood HealthCare Center	$ 3,080,643	5.3%	$ 5,161,617	8.6%
Saint Elizabeth's Medical Center	$ 568,000	2.1%	$ 542,000	2.0%
Sanford Health	$ 195,160,000	5.2%	$ 169,041,000	4.5%
Sleepy Eye Medical Center	$ 365,743	2.5%	$ 584,198	3.9%
St. Luke's Hospital	$ 13,751,000	3.3%	$ 14,644,000	3.5%
Stevens Community Medical Center	$ 4,315,883	11.2%	$ 4,612,036	11.9%
Swift County-Benson Hospital	$ (819,509)	-6.5%	$ (526,367)	-4.1%
Tri-County Hospital	$ 183,557	0.3%	$ 87,580	0.2%
United Hospital District	$ (136,861)	-0.5%	$ 3,969	0.0%
Windom Area Hospital	$ 1,120,701	7.0%	$ 1,149,201	7.1%
Winona Health Services	$ 2,336,720	1.9%	$ 4,119,504	3.3%

Source of the data

Data used for this analysis was abstracted from hospital and health system audited financial statements. This information is collected by MHA as documentation required under the state-mandated Health Care Cost Information System (HCCIS). The Minnesota Department of Health also maintains similar information as mandated by Minnesota Statutes 144.695-144.703.

Audited financial statement data is rigorously scrutinized by independent certified public accountant firms to ensure accuracy and consistency of reporting following generally accepted accounting practices and standards for reporting. This source is considered optimal for comparison financial analysis.

General acute care community hospitals are the basis of the analysis of operating margin. State- and federal-operated hospitals such as Community Behavioral Health Hospitals and the Veterans Health Administration medical centers were excluded from this review as they are financed and operated in different ways from community hospitals.