Minnesota Hospital Association

MHA Issue Brief: The Financial Health of Minnesota Hospitals and Health Systems in Fiscal Year 2016

December 2017

Introduction

Minnesota's hospitals and health systems have earned a national reputation as leaders in delivering high-quality, low-cost care and responding to the needs of their communities. This is the second annual report that the Minnesota Hospital Association (MHA) has issued related to our members' financial health. This report is unique because it documents the financial performance of Minnesota's hospitals and health systems using standard, independently audited data.

MHA's membership includes 142 of the 144 hospitals and health systems in Minnesota. All but two hospitals and health systems in Minnesota are operated as either private, not-for-profit charities or as government-owned organizations and are driven by missions dedicated to strengthening the health of the communities they serve.[1] The hospitals and health systems discussed in this report provide a wide array of services that span the entire continuum of care, from ambulance and primary care to hospice and mental health services – and from the most specialized and complex care, like organ transplants and burn care, to more routine preventive care and chronic disease management services that impact the largest portions of our population and help control the overall costs of care.

Therefore, while some of the statistics and trends summarized in this report pertain to hospitals specifically, MHA has gathered data and financial performance indicators reflecting these organizations' full scope of operations to provide the most complete picture possible. For accuracy of reporting, MHA's data derive from hospitals' and health systems' independently audited 2016 financial statements, as well as publicly available information collected by the Minnesota Department of Health (MDH).

Data sources, methodology and context

Analysis based on the most reliable sources

Data used for this report were abstracted from hospitals' and health systems' audited financial statements. This information is collected by MHA as part of hospitals' reporting requirements under the state-mandated Health Care Cost Information System (HCCIS). MDH maintains similar information as mandated by Minnesota Statutes sections 144.695-144.703.

1 There are two for-profit specialty hospitals operating in Minnesota.

To the greatest extent possible, MHA relies on audited financial statement data because they are rigorously scrutinized by independent, third-party, certified public accounting firms to ensure the data's accuracy and consistency following generally accepted accounting practices and reporting standards.[2] This data source is considered the most reliable and optimal for comparison financial analysis.

The hospital listing reflected in this report is comprised of margins from multihospital systems and individual independent hospitals. The system-level reporting is necessary for organizations for which financial records and accounting are reported as a single entity, making it is difficult to obtain or carve out audited and comparable hospital-level data. In a few exceptions, MHA has reported system-affiliated hospitals, such as Grand Itasca Clinic and Hospital and hospitals that are part of the St. Luke's, Ridgeview Medical Center and Avera Health systems, as separate entities because separate, hospital-level audited financial statements are available.

General, acute care community hospitals are the basis of MHA's analysis of operating margins. State- and federal-operated hospitals, such as Minnesota's Community Behavioral Health Hospitals and the Veterans Health Administration medical centers, are excluded from this review because they are financed and operated in different ways from community hospitals, making any statistical comparisons of financial performance confusing or even misleading.

To supplement this report's statewide information, MHA has included comparable national statistics when relevant and available to place Minnesota's results and trends into a larger context. Numerous data companies, consultants, lending institutions and credit ratings agencies produce financial comparison data targeted for hospitals of varying sizes, service types and locations. To identify a credible, third-party source of national comparison data, MHA contacted PiperJaffray, an investment bank with expertise in health care, for advice. PiperJaffray suggested that MHA use Standard & Poor's (S&P) as an appropriate source for national comparison data. Accordingly, relevant S&P national benchmarks are included in the discussion and graphics in this report.

Selecting the most meaningful measure of financial performance: operating margins v. net margins

Most often, the operating margin is the ratio MHA uses to evaluate hospitals' and health systems' financial performance. The operating margin is a measure of an organization's revenues compared with expenses that are related to its patient care services and activities. While many indicators are relevant to a thorough analysis of financial health and performance, the operating margin is the most recognizable, succinct, bottom-line measure. While there is no specific benchmark operating margin established for not-for-profit or government organizations, a positive operating margin is necessary to ensure their ongoing ability to serve patients in their community, to maintain strong credit ratings and affordable access to capital, and to recruit and retain the highly educated and skilled workforce necessary to care for patients.

Another factor referred to in this report is the net margin. An organization's net margin goes beyond performance on patient care operations by adding revenues and expenses related to nonpatient care activities, such as receiving donations, earning investment income or experiencing financial gains or losses from the disposal of assets. This report primarily focuses on organizations' operating margins because providing patient care services is the focus of each hospital's leadership and because operating margins are the most relevant and comparable measure of financial performance related to patient care services.

This report's analysis of the financial performance of hospital organizations, in conformance with the practice of many national sources, utilizes the median value of margins. The median figure represents the statistical middle value,

2 There are instances in which audited financial data are not available or would not be comparable. In these rare situations, MHA has noted the use of other data and provided a corresponding explanation.

whereby 50 percent of hospitals had margins above the median value and 50 percent had margins below this amount. Using the median value eliminates some of the statistical bias or skewing that a simple average can have, especially when there is great variation between small and large organizations.

For proper context, it is important to recognize the nonprofit or public status of the organizations under discussion. Unlike for-profit entities, not-for-profit and government-owned hospitals are not responsible for maximizing shareholders' income or using available margins to pay dividends, for example. Instead, net margins at not-for-profit or government-owned hospitals are reinvested back into the facilities and services that advance their community service missions and support access to high-quality medical services. For example, most of Minnesota's hospitals are part of an organization that provides other kinds of medical services, such as clinics, nursing homes, ambulance services, mental and behavioral health care, home health care and hospice services, that often generate low or even negative margins. Therefore, to meet these high-priority community needs, a positive margin earned from a hospital's patient care activities is used to cross-subsidize and financially support some of these nonhospital health care services.

Factors that often influence operating margin

A hospital's mix of payer sources can have a significant impact on its ability to achieve a positive operating margin. Serving a community with higher poverty rates, for example, tends to result in the hospital or health system receiving less revenue because it is caring for more uninsured or underinsured patients. Hospitals across the state all care for low-income, elderly and disabled residents in their communities, many of whom are covered by the state's Medicaid program, called Medical Assistance. The Medical Assistance program provider reimbursement rates are below the actual cost for delivering patient care. The most recent estimate from the state is that the Medical Assistance program's payments for inpatient care, for example, are only 71 percent of the actual costs hospitals incurred to provide that care.

The federal Medicare program, which provides coverage for the majority of Minnesotans over age 65, is another example of an underfunded government program that routinely reimburses hospitals below the actual costs of care.

Other factors that might result in lower revenues include each organization's commitment to providing services that are needed in the community but that have low- or even negative-margin financial impacts. Examples of low- or negative-margin services often include mental and behavioral health care, nursing home services or home health agencies. Because these factors result in lower revenues without decreasing expenses for patient care, the organization will face greater challenges to achieve or maintain a positive operating margin.

Uncompensated care costs, in the form of charity care write-offs and bad debt expenses, are a key challenge to a hospital's ability to achieve a positive operating margin. As health insurance companies increasingly enroll people in high-deductible health plans, which place greater financial responsibility on individual patients and their families, hospitals and health systems shoulder a higher exposure to unpaid expenses. Often, patients are unable to pay the deductible amounts they owe under the coverage terms established by their health plans. In addition, Minnesota still has an estimated 4.3 percent of the population lacking any health insurance coverage, according to the most recent Minnesota Health Access Survey published by MDH.

On the expense side, hospitals are heavily dependent on a highly educated and skilled workforce to deliver the sophisticated and life-saving care patients need. To recruit and retain these talented caregivers and employees, jobs at hospitals and health systems are often higher paying than other sectors, according to data from the U.S. Bureau of Labor and Statistics. Approximately 52 percent of hospitals' expenses are in the form of wages and benefits to recruit and retain all the members of the care team necessary to deliver great patient care. In many communities across Minnesota, workforce shortages in key clinical areas further increase compensation costs.

Health care, especially the complex level of care provided in hospitals, is a capital-intensive undertaking and requires hospitals and health systems to get capital bonds or loans to finance major projects or expensive equipment. In emergency and life-sustaining situations, patients need access to high-tech diagnostic imaging, laboratory equipment, pharmaceuticals, medical devices, 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 advance and regulatory requirements for construction and renovation of facilities continue to evolve.

While buildings and capital equipment are critical for patient care, their impact on an organization's margin, reflected in financial statements as annual interest and depreciation expenses, generally represents less than 6 percent of the average hospital's cost structure. The organizations that provide loans for capital projects and equipment, like bond agencies, charge higher interest rates for loans they make to organizations with low or negative operating margins and lower interest rates to organizations that generate positive operating margins. Accordingly, the ability for hospitals and health systems to get capital loans at lower interest rates increases the importance of achieving and maintaining positive margins. Steve Proeschel, head of health care finance at PiperJaffray, explained the importance of margins in this regard:

> *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.*

Remaining costs associated with patient care activities that affect margins include supplies, utilities, insurance and other related operating costs. Hospitals' margins, therefore, are affected when external market forces increase supply costs, such as the rapidly increasing cost of pharmaceuticals, or electricity and gas prices.

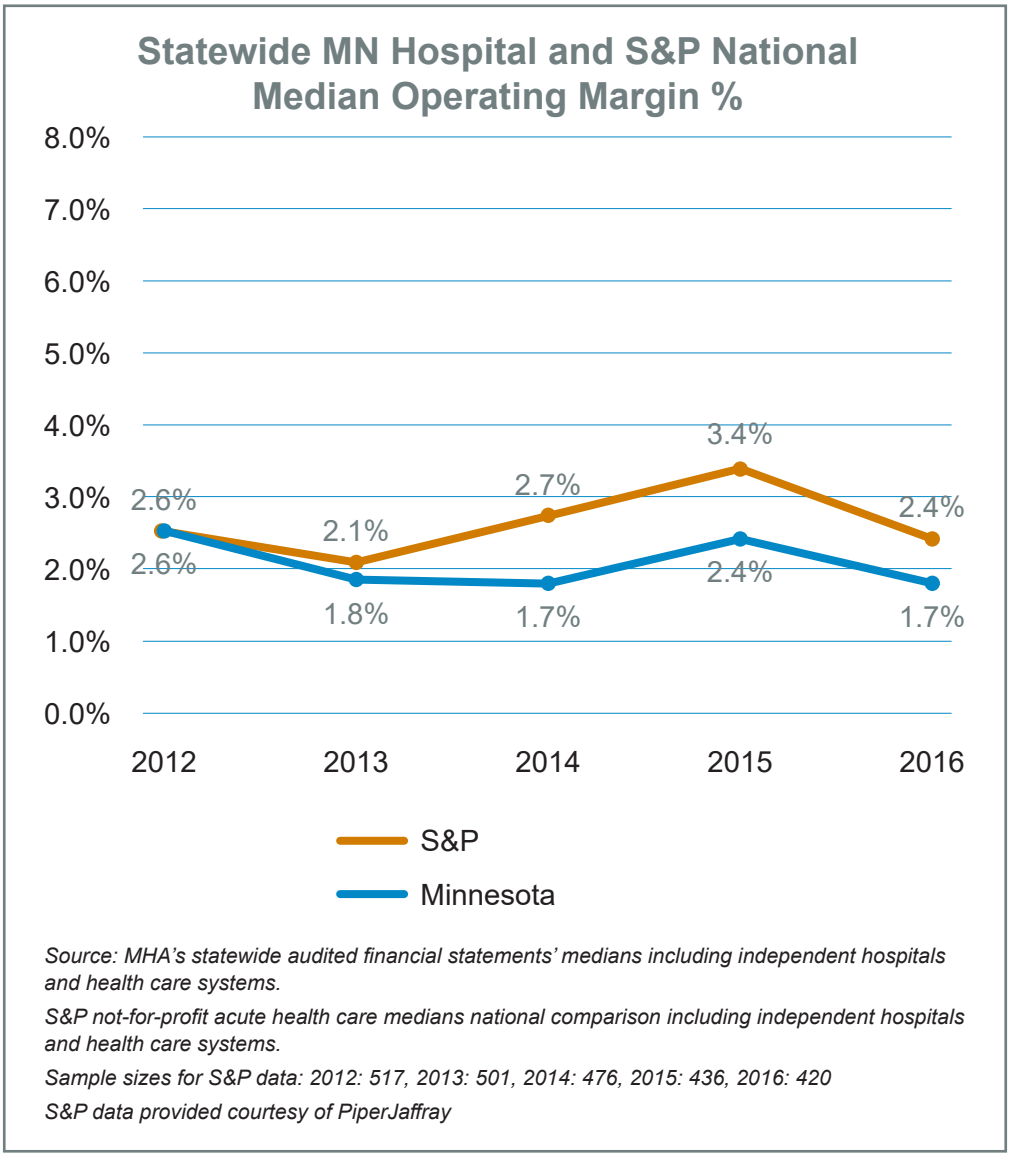
Minnesota hospitals' operating margins declined in 2016

Since 2012, the trend of overall median hospital operating margin in Minnesota has remained relatively steady at an average of just over 2 percent. A 29 percent drop in the median operating margin – from 2.4 percent in 2015 to 1.7 percent in 2016 – is concerning and reflects the major challenges facing hospitals and health systems in today's health care environment.

While 43 of Minnesota's general acute-care hospitals or systems shown in this report generated positive operating margins in 2016, MHA noted that 28 others, or 39 percent, experienced negative operating margins. The number of hospitals with negative operating margins increased from 21 in 2015.

There remains ongoing concern with the continued growth of uncompensated care costs from Minnesota's remaining uninsured population and its increasingly underinsured population, patients for whom high deductibles and copayment obligations are unaffordable. In addition, Minnesota's demographic statistics reflect a greater proportion of the population obtaining coverage through Medicare and Medicaid rather than commercial or employer-sponsored health plans.

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



Source: MHA's statewide audited financial statements' medians including independent hospitals and health care systems.

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

Sample sizes for S&P data: 2012: 517, 2013: 501, 2014: 476, 2015: 436, 2016: 420

S&P data provided courtesy of PiperJaffray

Operating margins continue to reflect differences between urban and rural hospitals

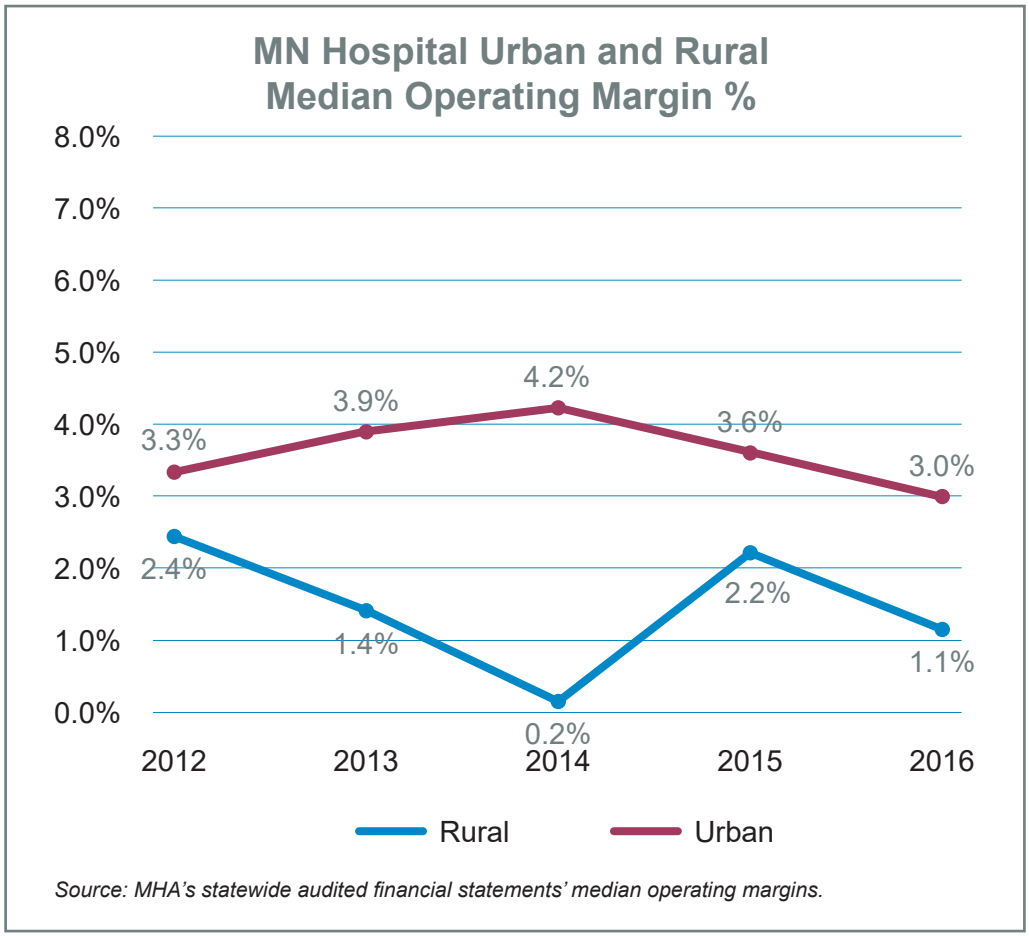
MHA's members include 34 urban hospitals and 108 rural hospitals. Of the 108 rural hospitals, 77 are critical access hospitals with 25 or fewer inpatient beds.

Overall, Minnesota's urban hospitals tend to have higher margins than rural hospitals. Rural hospitals tend to experience lower margins, on average, due to the smaller volumes of patients they treat and scope of services they provide. Rural hospitals also cross-subsidize a larger portion of their total operations to support other nonhospital health care services their communities need, such as nursing homes, ambulances, free-standing clinics and home health care.

Typically, rural hospitals serve communities with comparatively older populations and, on average, lower incomes. This leads to a higher proportion of patients covered by government-sponsored health care offerings, such as Medicare and Medicaid, rather than commercial market health plans. As noted earlier, Medicare and Medicaid often reimburse hospitals at rates set below the actual cost of care. Consequently, hospitals must rely on higher reimbursement rates from commercial health plans to cover this government underfunding. This need to collect higher rates from a part of the market to offset underpayments imposed by another sector of the market is referred to as the "cost shift," and it acts as a hidden tax on employers and individuals purchasing health insurance.

However, in recent years, Minnesota's commercial health plans have taken measures to cut payments to hospitals, especially rural hospitals, and to stop recognizing the reality of this cost shift and its role in ensuring access to care. This combination of more patients covered by government programs and reimbursement cuts from commercial health plans increases the likelihood of hospitals experiencing low or negative operating margins.

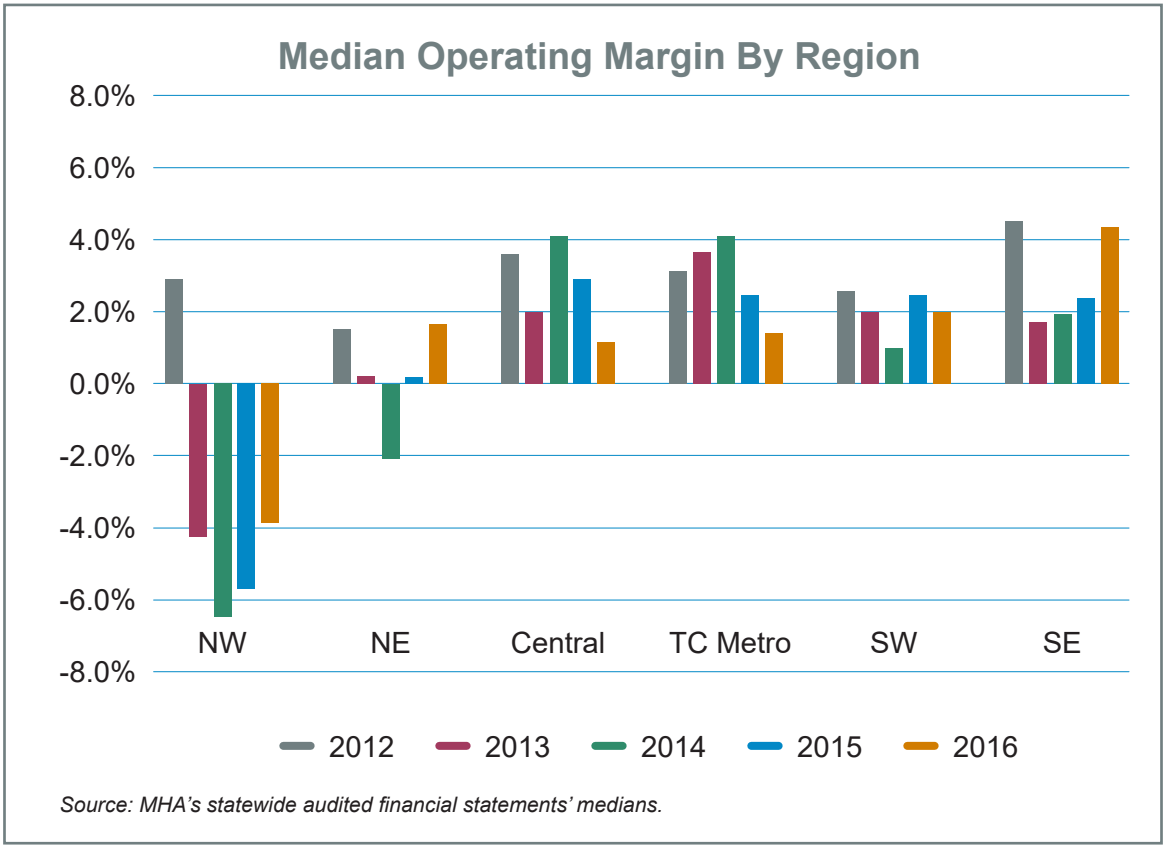
From 2012-14, urban and rural hospitals saw divergent trends in operating margins, with margins increasing at urban hospitals and decreasing at rural hospitals. However, the opposite occurred in 2015 when operating margins decreased at urban hospitals and increased at rural hospitals. Then, in 2016, the median operating margin declined for both urban and rural hospitals as the costs of charity care and bad debt expenses rose, cuts from health insurers took their toll and the portion of patients covered by Medicare and Medicaid continued to increase.



Source: MHA's statewide audited financial statements' median operating margins.

Much of the variation in operating margins in geographic regions of the state reflects differences in hospitals' size and local population mix.

From 2012-16, the six regions of the state have seen slightly differing operating margin results. Despite the variation noted, hospitals' positive median operating margins remain largely below 4 percent across the state. For 2016, three regions – Northwest, Northeast and Southeast – experienced median operating increases compared with 2015, while the other three regions experienced margin decreases. The improved margins are especially encouraging for the northern regions of the state where the median operating margins have been very low or negative for several years.



Source: MHA's statewide audited financial statements' medians.

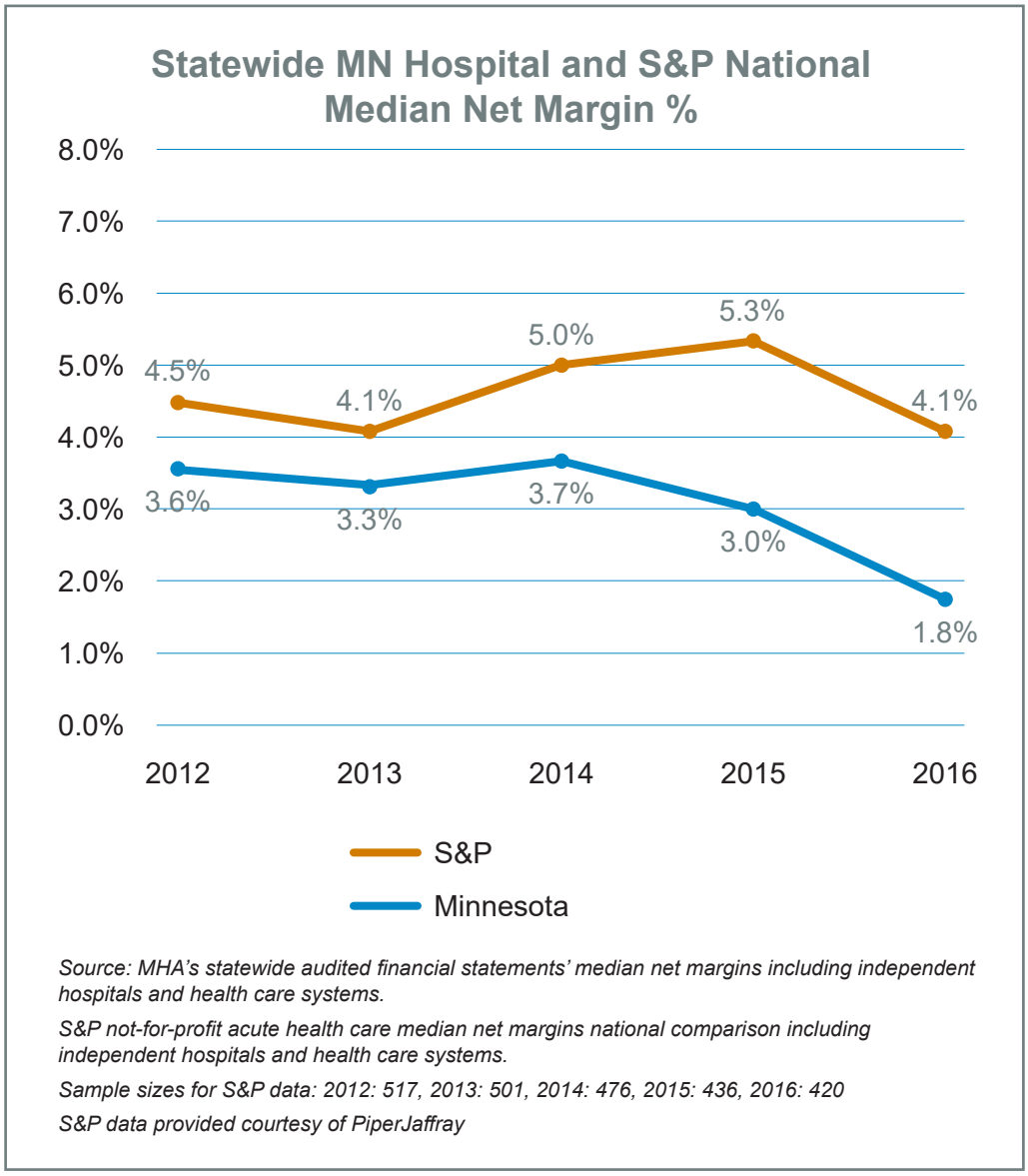
Hospital net margins also declined

As mentioned previously, the net margin reflects the overall financial impact of all revenues over all expenses during the fiscal year reporting period. It is comprised of both patient care-related and patient care-unrelated revenues over expenses, including donations, investment performance and disposal of assets, for example.

Minnesota hospitals' and health systems' net margin trend had been relatively stable for several years, but the noticeable decline in 2016 is a considerable departure from that trend. In addition, the divergence from the national median remains a concern for the ability of Minnesota's hospitals to continue providing low-cost care while remaining competitive with providers in other states.

The decline in net margin may be attributed to a variety of factors. Certainly, investment performance can be a leading indicator; while the investment market was relatively stable in 2016, some hospitals may have experienced other financing activities that produced negative results, such as disposing of assets, refinancing bonds or paying increased pension obligations.

The financial pressures faced by Minnesota hospitals could lead to discussions in local communities about the availability of certain services if revenues are not sufficient to support all of the services currently offered.



Source: MHA's statewide audited financial statements' median net margins including independent hospitals and health care systems.

S&P not-for-profit acute health care median net margins national comparison including independent hospitals and health care systems.

Sample sizes for S&P data: 2012: 517, 2013: 501, 2014: 476, 2015: 436, 2016: 420

S&P data provided courtesy of PiperJaffray

Hospital- and health system-specific operating and net margins

The chart below lists both the operating margin and net margin in total dollars and as percentages for each of Minnesota's hospitals and health systems. Detailed information about individual hospitals within multihospital health systems is not available because it is generally not presented in audited financial statements. In a few exceptions, MHA has reported system-affiliated hospitals, such as Grand Itasca Clinic and Hospital and hospitals that are part of the St. Luke's, Ridgeview Medical Center and Avera Health systems, as separate entities because separate audited financial statements were available for each of these hospitals. The figures presented below are based on the fiscal year-end operating period that ended in 2016.

Hospital	FY16 Operating Margin Dollars	Operating Margin %	FY16 Net Margin Dollars	Net Margin %
Allina Health	$ 119,247,000	3.0%	$ 60,601,000	1.5%
Appleton Area Health Services	$ (1,531,256)	-13.3%	$ (1,406,146)	-12.1%
Avera Marshall Regional Medical Center	$ 3,062,636	3.9%	$ 3,200,036	4.0%
Avera Tyler	$ (1,724,493)	-15.5%	$ (1,703,865)	-15.3%
Bigfork Valley Hospital	$ (693,499)	-3.0%	$ (94,569)	-0.4%
Catholic Health Initiatives	$ (483,316,000)	-3.0%	$ (703,207,000)	-4.4%
CentraCare Health	$ 50,342,562	4.2%	$ (26,428,558)	-2.2%
Children's Minnesota	$ 36,160,000	4.1%	$ 83,386,000	9.0%
Chippewa County-Montevideo Hospital	$ (967,292)	-2.5%	$ (519,523)	-1.3%
Community Memorial Hospital	$ 3,027,266	5.4%	$ 3,250,962	5.8%
Cook Hospital & Care Center	$ (400,542)	-3.0%	$ 830,749	5.7%
Cuyuna Regional Medical Center	$ 2,272,122	2.0%	$ 2,853,564	2.6%
Douglas County Hospital	$ 6,614,164	4.6%	$ 7,939,462	5.5%
Ely-Bloomenson Community Hospital	$ 334,335	2.0%	$ 694,051	4.1%
Essentia Health	$ 59,467,000	3.0%	$ 8,675,000	0.4%
Fairview Health Services	$ 130,637,000	3.0%	$ 221,202,000	5.0%
FirstLight Health System	$ 3,268,242	4.4%	$ 3,299,486	4.4%
Gillette Children's Specialty Healthcare	$ 9,495,325	3.9%	$ 15,495,564	6.2%
Glacial Ridge Health System	$ (37,275)	-0.1%	$ 320,697	1.0%
Glencoe Regional Health Services	$ 2,904,751	4.8%	$ 6,196,268	9.7%
Grand Itasca Clinic and Hospital	$ (1,334,457)	-1.6%	$ (619,797)	-0.7%
Granite Falls Health	$ (1,097,272)	-5.3%	$ (1,065,870)	-5.1%
HealthEast Care System	$ (7,034,000)	-0.7%	$ (7,854,000)	-0.8%
HealthPartners, Inc.	$ 99,858,000	1.7%	$ 112,181,000	1.9%
Hendricks Community Hospital Association	$ 846,724	6.2%	$ 853,384	6.2%
Hennepin Healthcare System Inc.	$ (49,700,000)	-5.1%	$ (45,236,000)	-4.7%
Hutchinson Health	$ 2,012,360	2.0%	$ 2,991,954	2.9%
Johnson Memorial Health Services	$ 1,766,065	10.1%	$ 2,216,739	12.3%
Kittson Memorial Healthcare Center	$ (643,712)	-4.8%	$ (486,554)	-3.6%
Lake Region Healthcare	$ (1,777,764)	-1.5%	$ 194,141	0.2%
Lake View Hospital	$ 1,558,870	10.0%	$ 2,244,192	13.7%
Lakewood Health System	$ 1,159,680	1.2%	$ 1,024,320	1.0%
LifeCare Medical Center	$ 4,737,007	10.3%	$ 5,212,708	11.2%
Madelia Community Hospital, Inc.	$ (203,832)	-1.8%	$ (1,946)	0.0%
Madison Hospital	$ 1,075,335	6.4%	$ 1,280,472	7.5%
Mahnomen Health Center	$ (1,155,134)	-14.8%	$ (791,749)	-9.7%
Mayo Clinic	$ 475,000,000	4.3%	$ 519,000,000	4.7%

Hospital	FY16 Operating Margin Dollars	Operating Margin %	FY16 Net Margin Dollars	Net Margin %
Meeker Memorial Hospital	$ (117,456)	-0.4%	$ 315,117	1.0%
Mercy Hospital	$ (49,092)	-0.1%	$ 454,518	1.3%
Mille Lacs Health System	$ (657,322)	-1.7%	$ (564,908)	-1.4%
Murray County Memorial Hospital	$ (1,941,653)	-12.0%	$ (1,863,698)	-11.4%
North Memorial Health	$ (78,606)	0.0%	$ 24,422,405	2.7%
North Shore Health	$ (793,436)	-5.6%	$ 53,452	0.4%
North Valley Health Center	$ (996,270)	-10.5%	$ (956,348)	-10.0%
Northfield Hospital	$ 432,806	0.4%	$ 964,397	0.9%
Olmsted Medical Center	$ 18,973,563	9.6%	$ 22,077,625	11.0%
Ortonville Area Health Services	$ 926,160	3.2%	$ 1,057,180	3.6%
Perham Health	$ 1,276,849	2.5%	$ 2,428,495	4.7%
Pipestone County Medical Center	$ (286,419)	-1.1%	$ 509,628	1.8%
Prairie Ridge Hospital & Health Services	$ (772,358)	-4.5%	$ (730,581)	-4.2%
Rainy Lake Medical Center	$ 713,653	2.7%	$ 861,031	3.3%
RC Hospital	$ 1,562,325	5.7%	$ 2,025,057	7.2%
Redwood Area Hospital	$ 1,665,661	6.4%	$ 1,560,957	5.9%
Regency Hospital of Minneapolis	$ 6,980,546	16.6%	$ 7,254,437	17.1%
Rice Memorial Hospital	$ 1,023,603	0.9%	$ 1,760,885	1.6%
Ridgeview Le Sueur Medical Center	$ 689,331	5.5%	$ 730,638	5.8%
Ridgeview Medical Center	$ 2,741,194	1.1%	$ 3,918,705	1.6%
Ridgeview Sibley Medical Center	$ 1,095,004	8.0%	$ 1,051,677	7.7%
River's Edge Hospital & Clinic	$ 1,366,082	4.3%	$ 1,406,428	4.4%
RiverView Health	$ 4,468,720	7.8%	$ 4,528,541	7.9%
Riverwood Healthcare Center	$ 2,185,445	3.7%	$ 2,281,957	3.8%
Saint Elizabeth's Medical Center	$ (1,105,325)	-3.9%	$ (1,189,860)	-4.2%
Sanford Health	$ 130,444,000	3.1%	$ 142,198,000	3.3%
Sleepy Eye Medical Center	$ (625,836)	-4.1%	$ (427,526)	-2.7%
St. Luke's Hospital	$ 6,063,189	1.4%	$ 7,150,016	1.7%
Stevens Community Medical Center	$ 1,682,655	4.3%	$ 1,813,444	4.7%
Swift County-Benson Health Services	$ (2,081,006)	-14.3%	$ (2,014,523)	-13.8%
Tri-County Hospital	$ 722,109	1.2%	$ 1,025,121	1.7%
United Hospital District	$ 42,431	0.1%	$ 201,280	0.7%
Windom Area Hospital	$ 665,745	4.1%	$ 707,139	4.3%
Winona Health Services	$ (2,699,216)	-2.2%	$ (1,508,562)	-1.2%