Minnesota Hospital Association

MHA Issue Brief: The Financial Health of Minnesota Hospitals and Health Systems in Fiscal Year 2018

February 2020

Introduction

Minnesota's hospitals and health systems have earned a national reputation as leaders in delivering high-quality, lower-than-the-national-average cost of care and meeting the needs of their communities. This is the fourth annual report the Minnesota Hospital Association (MHA) has produced related to our members' financial health and trends. This report is the most accurate depiction of Minnesota hospitals' and health systems' financial positions because it draws from standard, independently audited data.

This report reflects 78 hospitals and health systems in Minnesota. All but two[1] of Minnesota's hospitals 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. 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 are derived from hospitals' and health systems' independently audited 2018 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.

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

1 There are two for-profit specialty hospitals operating in Minnesota: Regency Hospital of Minneapolis and PrairieCare.

generally accepted accounting practices and reporting standards.[2] This data source is considered the most reliable and optimal for comparing financial performance – the gold standard.

This report lists both individual hospitals and health systems. Where possible, data are reported at the individual hospital level. However, system-level reporting is necessary for organizations in which financial records and accounting are reported as a single entity, such as Allina Health and M Health Fairview. For a few exceptions, MHA has reported system-affiliated hospitals, such as those that are part of the Avera Health, Ridgeview Medical Center and St. Luke's systems, as separate entities because their hospital-level audited financial statements are available. In addition, for systems that are primarily headquartered in other states, MHA has shown the hospital-level detail to more accurately reflect the Minnesota portion of their systems' activities. Minnesota hospitals owned and operated by Catholic Health Initiatives (CHI) and Sanford Health are examples of system-affiliated hospitals that are part of health systems headquartered in other states.

General, acute care community hospitals and health systems 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 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 maintain a consistent approach, MHA has relied on Piper Sandler Companies (formerly Piper Jaffray), an investment bank with expertise in health care, to supply the Standard & Poor's (S&P) medians as an appropriate source for national comparison data benchmarks.

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

Most often, the operating margin is the ratio MHA relies on to evaluate hospitals' and health systems' financial performance. The operating margin is a measure of an organization's revenues compared with its expenses that are related to patient care services and activities. While many indicators are relevant for 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 hospitals and health systems 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 hospitals and health systems, in conformance with the practice of many national sources, utilizes the median value of margins. The median figure represents the statistical middle value, whereby 50% of organizations had margins above the median value and 50% 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.

---

2 There are instances in which audited financial data are not available or would not be comparable. In these situations, MHA used either internal financial statements or Hospital Annual Report data reported through HCCIS.

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 pressured to maximize shareholders' income or to disperse 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 that often generate low or even negative margins, such as clinics, nursing homes, ambulance services, mental and behavioral health care, home health care and hospice services. Therefore, to meet these high-priority community needs, a positive margin earned from hospital patient care services is used to cross-subsidize and financially support some of these nonhospital health care services for the community.

Factors that often influence operating margin

A hospital's mix of payer sources significantly impacts its ability to achieve a positive and sustainable 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 proportionately 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, and the MinnesotaCare program. The Medical Assistance program's provider reimbursement rates are below the actual cost for delivering patient care. The most recent estimate from MHA shows the Medical Assistance program's fee-for-service payments support only 74% of the actual costs hospitals incurred to provide that care.[3]

The federal Medicare program, which provides coverage for the majority of Minnesotans over age 65, routinely reimburses hospitals below the actual costs of care they provide.

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 margins. Examples of low- or negative-margin services often include mental and behavioral health care, nursing home services or home health agencies. Because these services 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 more losses from 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 6.3% of our population lacking any health insurance coverage, according to the most recent Minnesota Health Access Survey published by MDH.[4]

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

Health care delivery systems are also heavily dependent on a highly educated and skilled workforce to deliver the sophisticated and lifesaving care patients need. In addition, Minnesota's teaching hospitals invest in medical education to train the next generation of caregivers. To recruit and retain these talented caregivers and employees, jobs at hospitals and health systems typically pay higher wages and salaries than other sectors, according to data from the U.S. Bureau

3 Based on analysis done by MHA using data from the Health Care Cost Information System.

4 MDH's Minnesota Health Access Survey published February 2018 based on 2017 results.

of Labor and Statistics. Approximately 52% of a typical hospital's 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, providers depend on high-tech diagnostic imaging, sophisticated laboratory equipment, increasingly expensive pharmaceuticals, medical devices, scopes and scanners – along with highly skilled medical providers – to achieve the best outcomes for patients. 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.

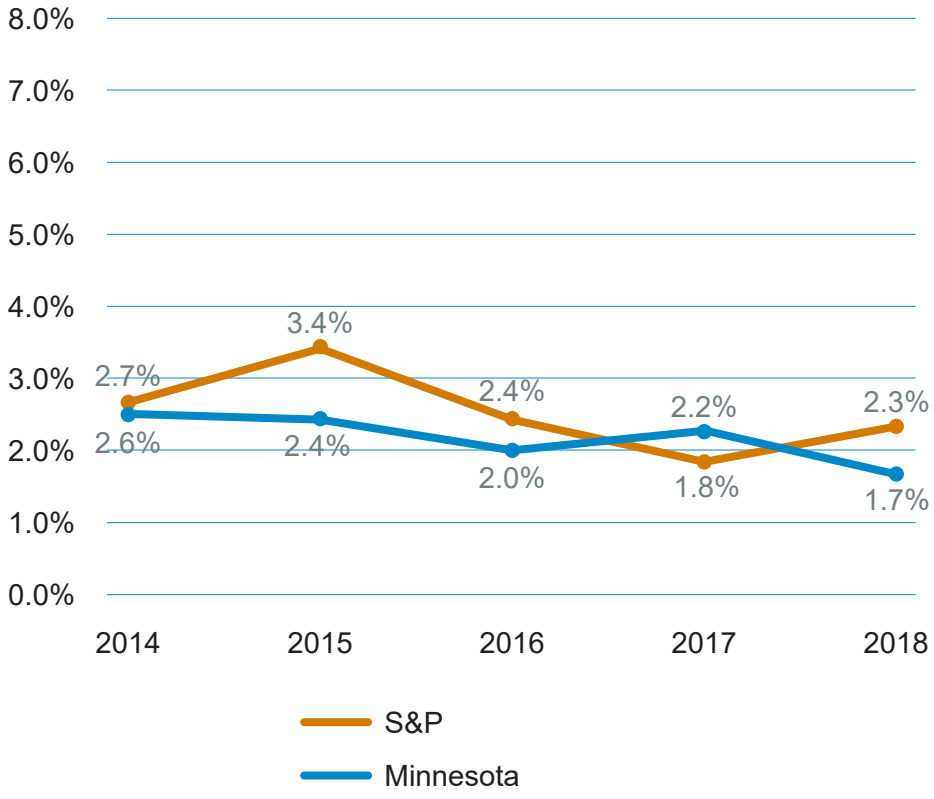
While buildings and capital equipment are critical for patient care, their impact on an organization's margin, reflected in financial statements as annual interest and depreciation expenses, generally represents less than 6% of the average hospital's cost structure. The organizations that provide loans 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 consistently generate positive operating margins. Accordingly, the ability for hospitals and health systems to get capital loans at lower interest rates, and therefore reduce costs to patients, further increases the importance of achieving and maintaining positive margins. Steve Proeschel, managing director and head of health care finance at Piper Sandler Companies, 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.*

Minnesota hospitals' operating margins declined in 2018

Since 2014, the trend of overall median hospital operating margin in Minnesota has remained steady at just over 2%. In 2018, however, the median operating margin declined to 1.7% – a signal that Minnesota's hospitals and health systems are experiencing challenges including pressure to reduce costs from both government and commercial payers; health care professional shortages; and increasing costs of products and supplies such as pharmaceuticals, devices and technology systems for electronic health records.

While 51 of Minnesota's hospitals and health systems shown on this report generated positive operating margins in 2018, MHA noted that 27 hospitals, or 34% of the hospitals and health systems reflected in this report, experienced negative operating margins. This number compares with 26 showing negative operating margins in 2017.



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

Trend figures for Minnesota may differ from previous reports due to changes in reporting of hospital entities.

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

Sample sizes for S&P data: 2014: 476, 2015: 436, 2016: 420, 2017:406, 2018: 400.

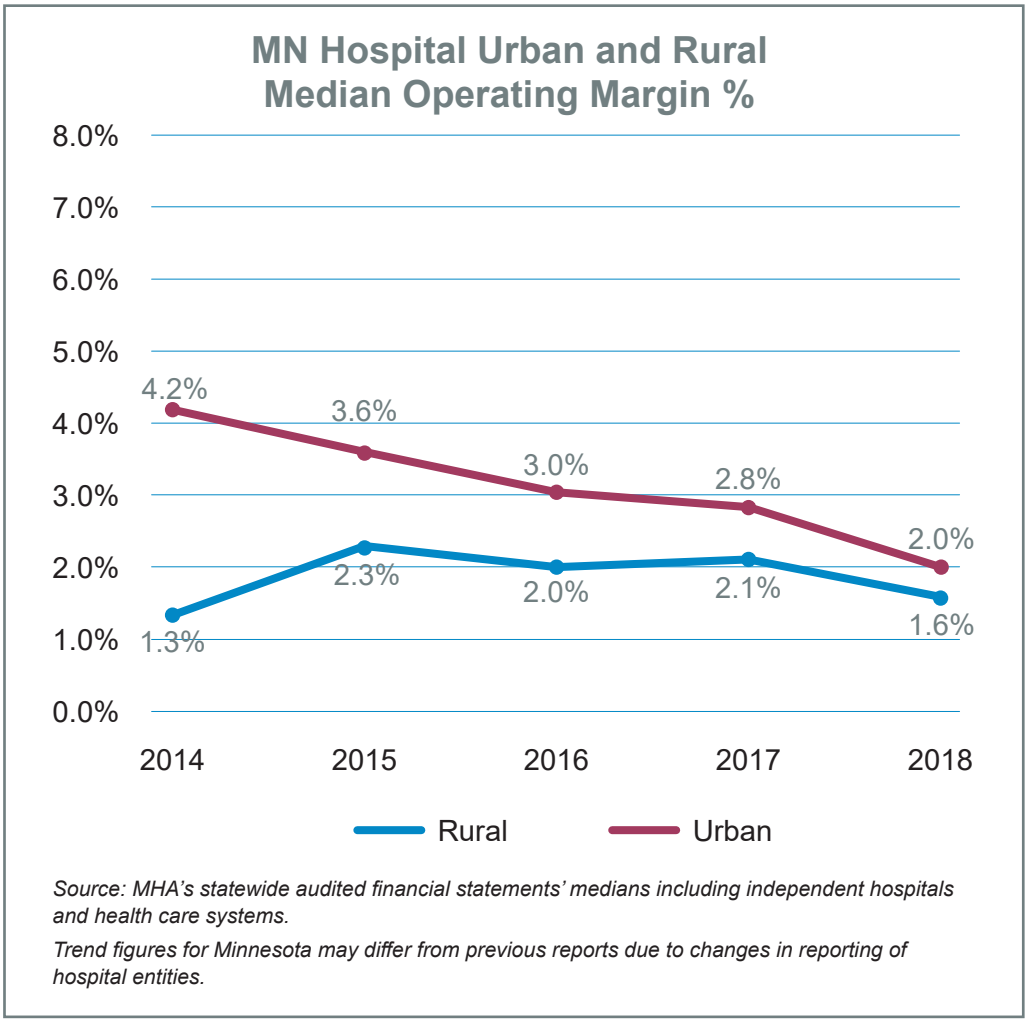
S&P data provided courtesy of Piper Sandler Companies.

When stratifying margins based on individual hospitals versus multihospital health systems, 20 individual hospitals shown in this report had negative operating margins in 2018, while 7 hospitals that are part of multihospital systems had negative operating margins.

There remains ongoing concern with the continued growth of uncompensated care costs from Minnesota's uninsured population and its increasingly underinsured population, including patients with high deductibles and copayment obligations they cannot afford. In addition, Minnesota's hospitals and health systems are seeing increasing numbers of patients covered through government-sponsored programs such as Medicare, Medicaid and MinnesotaCare. With reimbursement rates from government-sponsored programs typically below the cost of care, this puts pressure on hospitals to cross-subsidize losses through negotiated rates with commercial insurers.

Urban and rural median operating margins are narrowing

Historically Minnesota's urban hospitals have had higher margins than rural hospitals; however, the gap has narrowed in recent years. Rural hospitals experience lower margins, on average, due to the smaller volumes of patients they treat and scope of services they provide. Many 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.



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

Trend figures for Minnesota may differ from previous reports due to changes in reporting of hospital entities.

All hospitals rely on higher reimbursement rates from commercial health plans to cover government underfunding. This cost shift occurs when underpayments imposed by one sector of the payer market are offset by higher payments from another sector. Some hospitals, such as safety net hospitals and small, rural hospitals, serve communities with older populations and, on average, lower incomes compared with hospitals situated in areas of population that are younger and more affluent. This leads to a higher proportion of patients covered by government-sponsored health care programs, such as Medicare and Medicaid. Hospitals with higher proportions of government-sponsored payers often struggle more financially. As noted earlier, Medicare and Medicaid routinely reimburse hospitals at rates set below the actual cost of care.

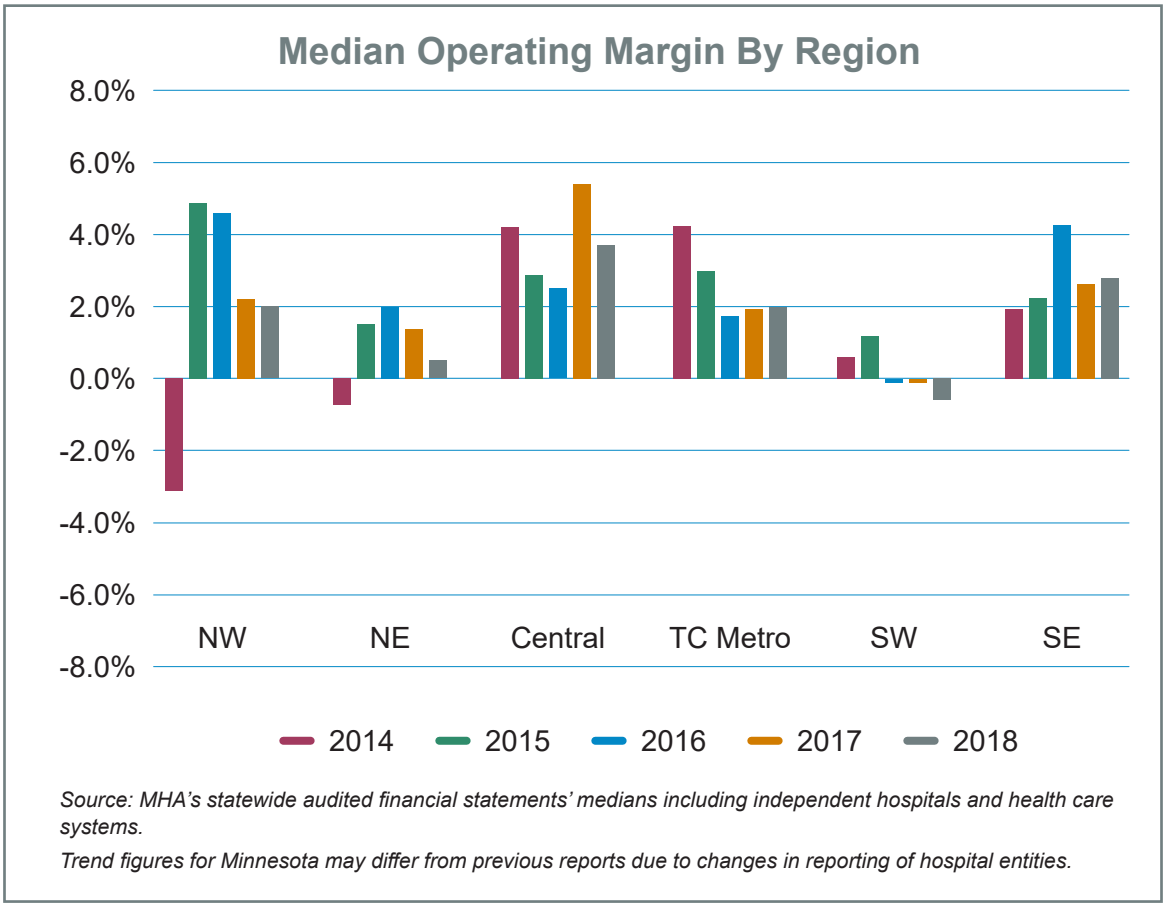
In recent years, Minnesota's commercial health plans have taken measures to cut payments to hospitals, especially rural hospitals, despite the role this cost shift plays in ensuring access to care. The combination of more patients covered by government programs and reimbursement cuts from commercial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

While urban and rural hospital median operating margins have been divergent, the trend in recent years has been convergence with urban and rural hospitals showing downturns in 2018.

Operating margin trends by geographic region

Much of the variation in operating margins in geographic regions of the state reflects differences in hospitals' size and local population mix. MHA's regional map (see Appendix A) was used to identify hospitals by region.

From 2014-18, 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% across the state. Hospitals in most regions of the state experienced a decline of median operating margins. The median operating margins for rural hospitals in the Northeast and Southwest regions have trended lower than other regions at or below 2% for five years.



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

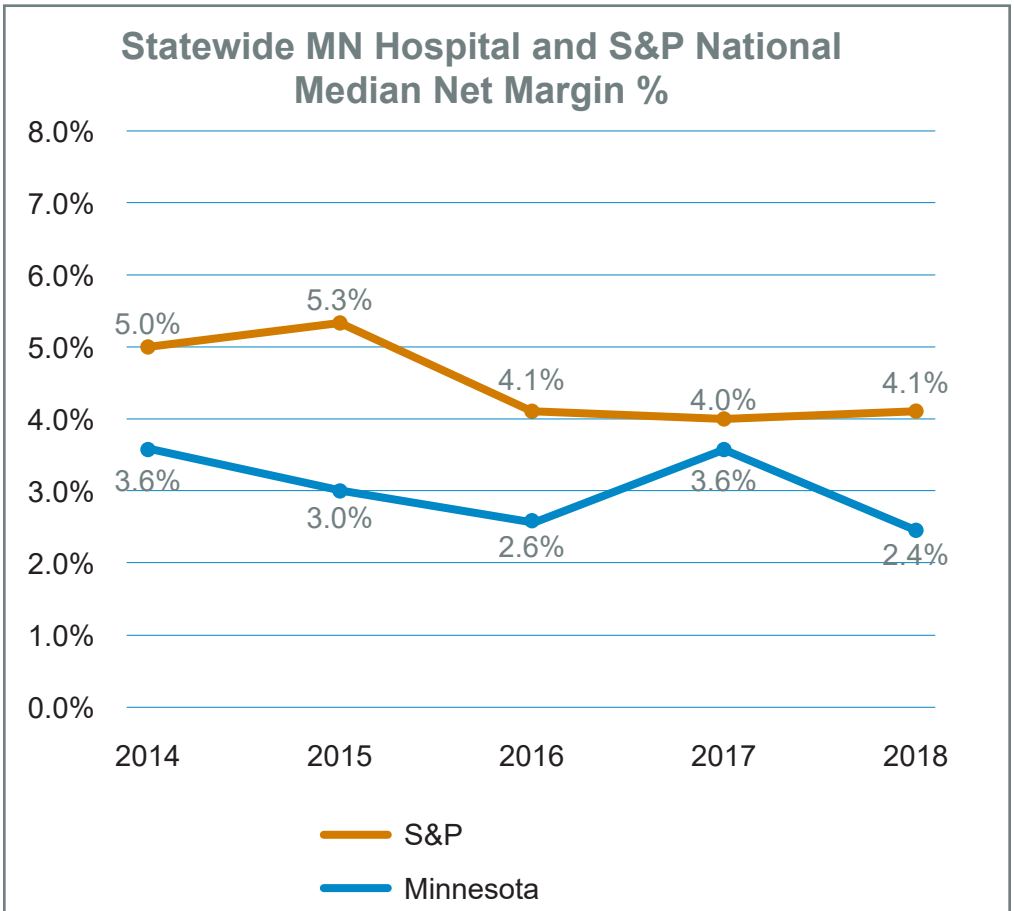
Trend figures for Minnesota may differ from previous reports due to changes in reporting of hospital entities.

Hospital net margins 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 nonpatient care-related revenues over expenses, including donations, investment performance and disposal of assets, for example.

Minnesota hospitals' and health systems' net margin trend has been relatively stable for the five-year period, with a noticeable decrease in 2018. In addition, the gap between Minnesota's median and the national median has widened again.

The decrease 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 2018, there was a sharp drop in the market at the end of the year. Additionally, some hospitals may have experienced other financing activities that produced varying results, such as disposal of assets, refinancing bonds or changing pension obligations.



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

Trend figures for Minnesota may differ from previous reports due to changes in reporting of hospital entities.

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

Sample sizes for S&P data: 2014: 476, 2015: 436, 2016: 420, 2017: 406, 2018: 400.

S&P data provided courtesy of Piper Sandler Companies.

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 those that are part of Avera Health, Catholic Health Initiatives (CHI), Ridgeview Medical Center, Sanford Health and St. Luke's as separate entities because separate audited financial statements were available or because their system headquarters are primarily located outside of Minnesota. The figures presented below are based on the fiscal year-end operating period that ended in 2018.

Hospital	FY2018 Operating Margin Dollars	Operating Margin %	FY2018 Net Margin Dollars	Net Margin %
Allina Health	86,258,000	2.0%	22,384,000	0.5%
Alomere Health *	15,325,534	8.8%	14,821,959	8.6%
Appleton Area Health *	(79,782)	-0.6%	(36,289)	-0.3%
Avera Granite Falls *	(764,386)	-3.1%	(717,548)	-2.9%
Avera Marshall Regional Medical Center	2,951,218	3.4%	5,562,278	6.3%
Avera Tyler	528,548	4.7%	535,182	4.7%
Bigfork Valley Hospital *	(1,856,664)	-8.3%	(1,303,739)	-5.7%
CCM Health *	(1,259,164)	-3.0%	(799,963)	-1.9%
CentraCare	24,923,000	1.7%	144,714,000	8.9%
CHI LakeWood Health	(1,721,806)	-12.6%	(769,627)	-5.3%
CHI St. Francis Health	2,304,206	7.3%	7,401,295	20.3%
CHI St. Gabriel's Health	2,822,676	3.7%	3,905,581	5.1%
CHI St. Joseph's Health	5,950,745	10.8%	8,782,500	15.2%
Children's Minnesota	51,433,000	5.4%	46,386,000	4.9%
Community Memorial Hospital	(2,022,151)	-3.6%	(1,749,049)	-3.1%
Cook Hospital & Care Center *	(689,701)	-5.0%	681,690	4.5%
Cuyuna Regional Medical Center	5,598,027	4.5%	5,893,767	4.7%
Ely-Bloomenson Community Hospital	568,314	3.0%	957,132	4.9%
Essentia Health	10,964,000	0.5%	101,153,000	4.7%
Gillette Children's Specialty Healthcare	11,870,225	4.6%	4,441,836	1.8%
Glacial Ridge Health System *	(549,782)	-1.4%	(144,850)	-0.4%
Glencoe Regional Health	421,175	0.7%	158,530	0.3%
HealthPartners, Inc.	146,528,000	2.1%	180,955,000	2.6%
Hendricks Community Hospital Association	(199,381)	-1.4%	(156,971)	-1.1%
Hennepin Healthcare *	1,663,000	0.2%	2,923,000	0.3%
Johnson Memorial Health Services *	289,373	1.7%	780,504	4.4%
Kittson Memorial Healthcare Center	(371,485)	-2.5%	(233,824)	-1.6%
Lake Region Healthcare	(1,434,213)	-1.1%	1,900,255	1.5%
Lake View Hospital	1,485,792	8.3%	851,376	4.9%
Lakewood Health System	2,965,069	2.9%	2,861,757	2.8%
LifeCare Medical Center	5,179,460	10.4%	5,710,695	11.3%
M Health Fairview	96,691,000	1.7%	11,090,000	0.2%
Madelia Community Hospital Inc.	(1,047,333)	-10.1%	(740,489)	-6.9%
Madison Healthcare Services	(2,159)	0.0%	241,655	1.4%
Mahnomen Health Center *	167,395	1.9%	276,845	3.1%
Mayo Clinic Health System	706,000,000	5.6%	554,000,000	4.4%
Meeker Memorial Hospital & Clinics *	1,987,618	5.9%	2,609,440	7.6%

Mercy Hospital, Moose Lake *	(120,247)	-0.3%	624,017	1.7%
Mille Lacs Health System	1,428,091	3.4%	1,537,785	3.6%
Murray County Medical Center *	(901,339)	-5.8%	(762,268)	-4.8%
North Memorial Health	6,435,330	0.7%	(6,722,966)	-0.7%
North Shore Health *	(2,519,414)	-15.2%	(1,223,194)	-6.8%
North Valley Health Center	(646,168)	-6.1%	(580,047)	-5.5%
Northfield Hospital & Clinics *	2,388,987	2.2%	2,083,316	1.9%
Olmsted Medical Center	8,195,071	4.0%	8,165,149	4.0%
Ortonville Area Health Services *	439,084	1.4%	431,801	1.4%
Perham Health *	1,795,072	3.2%	3,595,908	6.2%
Pipestone County Medical Center *	(755,947)	-2.5%	1,164,706	3.6%
Prairie Ridge Hospital and Health Services	(679,787)	-3.9%	(562,584)	-3.2%
Rainy Lake Medical Center	538,207	2.0%	608,050	2.3%
RC Hospital & Clinics *	4,057,543	12.5%	4,484,027	13.6%
Regency Hospital of Minneapolis	7,150,593	14.7%	5,736,970	12.1%
Ridgeview Le Sueur Medical Center	204,680	1.7%	253,609	2.1%
Ridgeview Medical Center	4,451,832	1.7%	6,368,853	2.4%
Ridgeview Sibley Medical Center	917,160	5.9%	766,306	5.0%
River's Edge Hospital & Clinic *	3,237,174	8.3%	2,552,191	6.7%
RiverView Health	1,260,569	2.0%	1,412,111	2.2%
Riverwood Healthcare Center	4,114,220	6.5%	6,113,566	9.3%
Saint Elizabeth's Medical Center	(6,971,394)	-20.7%	(6,971,394)	-20.7%
Sanford Bagley Medical Center	952,396	8.1%	1,000,079	8.4%
Sanford Bemidji Medical Center	11,672,081	4.0%	12,489,194	4.3%
Sanford Canby Medical Center	102,625	0.5%	103,719	0.5%
Sanford Jackson Medical Center	2,581,411	20.4%	2,635,630	20.8%
Sanford Luverne Medical Center	2,968,838	11.1%	2,999,048	11.2%
Sanford Thief River Falls Medical Center	5,625,824	8.0%	5,634,441	8.0%
Sanford Tracy Medical Center	(247,788)	-2.7%	(36,744)	-0.4%
Sanford Westbrook Medical Center	(204,921)	-2.9%	(139,547)	-1.9%
Sanford Wheaton Medical Center	488,223	6.1%	569,231	7.1%
Sanford Worthington Medical Center	(4,483,708)	-10.8%	(4,467,382)	-10.7%
Sleepy Eye Medical Center *	(351,525)	-2.2%	(132,503)	-0.8%
St. Luke's Hospital	29,644,000	5.8%	33,558,000	6.5%
Stevens Community Medical Center	(272,488)	-0.7%	49,107	0.1%
Swift County-Benson Health Services *	(638,314)	-3.8%	(591,972)	-3.5%
Tri-County Health Care	2,888,489	4.3%	2,769,808	4.2%
United Hospital District	(576,142)	-1.7%	(255,247)	-0.8%
Welia Health *	6,037,871	6.9%	5,378,317	6.2%
Windom Area Health *	294,154	1.6%	389,738	2.1%
Winona Health Services	945,987	0.8%	2,016,247	1.6%

** Government-owned hospitals' margins may be impacted by fluctuations in Public Employees Retirement Association (PERA) pension obligations.*

In addition, some government-owned hospitals classify interest expense as nonoperating expense. For the analysis in this report, MHA reclassified interest expense into operating expense in these situations to keep the reporting consistent.

Appendix A

MHA regional map