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On Solid Ground

Revenue gains continue to outpace growth in expenses, allowing U.S. hospitals to enjoy record profit and margin

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Surging profits last year produced hospitals' largest margin since Congress sharply curbed payments from Medicare a decade ago, continuing a steady rebound that's been under way since 2002.

Profits for U.S. general acute-care hospitals hit a record high of \$35.2 billion in 2006—a one-year jump of more than 20%—on net revenue of \$587.1 billion for a margin of 6%. The last time the industry collectively saw such a windfall was in 1997, when operating and investment gains delivered a 6.7% profit margin. Hospitals can credit a widening gap between revenue and expense growth for the banner year. In 2006, expenses flagged behind revenue, which grew 7% and 7.8%, respectively, compared with 7.2% and 7.3% a year earlier.

The figures—the aggregate financial results of more than 4,920 hospitals—don't reflect the average U.S. hospital's performance, but do offer a compelling measure of the industry's health. And last year's results underscore how robust returns and improved operations have buoyed balance sheets across the sector.

Greater efficiency, more clout with private payers and improved reimbursement from Medicare—hospitals' single-largest payer—have helped fuel continued gains for hospitals, said industry insiders and experts. Stephen Zuckerman, a health economist at the Urban Institute, said the industry has seen a swing toward more favorable reimbursement from private and public payers as managed care's influence faded earlier this decade, and as Congress reversed some prior Medicare cost-containment efforts.

Consolidation and losses in the late 1990s prompted hospital executives to go “back to the basics” in recent years, a strategy that healthcare analyst Lisa Goldstein said has paid off. “They shed or divested or closed a lot of unprofitable business lines, and they also focused on their rates,” said Goldstein, a senior vice president at Moody's Investors Service.

Despite slightly softer finances last year among the not-for-profits rated by Moody's, performance remains historically strong, she said. The median net margin among roughly 400 hospitals and systems dipped to 4.9% in 2006 from 5.1% the prior year. Operating margins slipped slightly as well, to 2.3% from 2.7%, and expenses nudged ahead of revenue, growing 7.8% and 7.6%, respectively. Goldstein cited weak admissions, rising expenses and mounting losses from patients who don't or can't pay their bills as factors that have eroded performance. Still, many providers enjoyed record performance last year, Goldstein said, calling the market overall “pretty strong.”

Hospitals' aggregate operating revenue growth held steady at 7.3% last year, totaling \$574.9 billion, according to the American Hospital Association. The operating margin rose to 4% in 2006 from 3.7%. Meanwhile, investment returns and other nonoperating revenue grew 35% to \$12.2 billion. Not-for-profit hospitals enjoyed unusually strong returns last year, according to the Commonfund Benchmarks Study Healthcare Report (Oct. 8, p. 20).

Revenue climbed with rising outpatient and emergency room visits, the latter fueled in part by two trends that have put increasing strain on the hospital industry: an aging population and rising rates of uninsured, said Caroline Steinberg, vice president of trends analysis for the Chicago-based AHA.

All outpatient visits—including those to the emergency room—rose 2.6%, slightly faster than the 2.2% in 2005. Emergency room visits increased 3.2%, which outpaced the 2% growth the prior year.

Separately, the AHA reported hospitals' estimated losses from Medicare, Medicaid and uncompensated care rose again in 2006 (See related story, p. 8).

Steinberg called hospitals' 2006 performance "pretty stable," and noted that aggregate figures mask the roughly one-third of U.S. hospitals that operate at a loss. She said workforce shortages and information technology investments will drive expense growth, though the data suggest hospital efficiency improved last year. The number of patients admitted to hospitals nudged upward as the total number of days patients needed to be hospitalized dipped slightly, Steinberg said. Patients' average length of stay in 2006 remained flat at 5.6 days.

The AHA collects operations and financial figures from registered general acute-care hospitals. Last year, the number of those hospitals dipped by nine to 4,927. Ownership also fluctuated in 2006. The number of public not-for-profit hospitals increased by nearly 1% to 1,119 and the number of investor-owned hospitals rose a little more than 2% to 889. Meanwhile, the figures show a roughly 1% drop in the number of private not-for-profit hospitals to 2,919.

Executives at financially strong health systems said last year's results grew out of sustained, multiyear efforts to boost performance and improve operations.

"Generally, it's not a home run," said Stanley Hupfeld, president and chief executive officer of 10-hospital Integris Health. "It's a series of singles."

Integris, based in Oklahoma City's highly competitive market, closed its books June 30, 2006, with a 5% increase in operating revenue, financial records show. That's despite a 3.6% drop in admissions, Moody's noted in a November 2006 ratings report. Last year's gains followed six years of record-setting performance, which continued in fiscal 2007, the ratings agency said in October. Integris saw admissions fall 2.4% for the year that ended June 30, but operating revenue rose to \$1.16 billion from \$1.07 billion in 2006. Its operating margin continued to climb to 5% from 4.7% a year earlier, thanks in part to good contracts with payers, less waste and sicker patients, Moody's reported.

Hupfeld said the not-for-profit system, Oklahoma's largest, has seen finances improve with a substantial turnaround at its eight rural hospitals.

Expansion efforts, aided by Integris' continued financial strength, helped boost the system's smaller, remote hospitals, he said. In 2002, Integris' rural hospitals collectively lost \$8.4 million, he said. Recruiting surgeons, expanding services and investing in technology increased rising profits. Last year, the eight hospitals reported a \$6.8 million profit, which increased to \$7.8 million in 2007, he said. During the past year-and-a-half, the system has also begun a systematic push to improve efficiency, he said, to combat the industry's fast-rising expenses and eliminate waste. "If you do nothing, you can count on 6% to 10% inflation between your supplies and your labor costs," he said. "Very quickly your profit margin deteriorates."

Elizabeth Concordia, president of the Hospital and Community Services Division and executive vice president of the University of Pittsburgh Medical Center system, said efforts to improve efficiency and quality at the 12-hospital system have stressed ongoing consolidation and integration to wipe out waste and errors.

The not-for-profit system moved its obstetric services from its UPMC Presbyterian Shadyside campus to its 223-bed Magee-Womens Hospital in November 2004, opening much-needed floors at UPMC Presbyterian Shadyside to expand urology services.

An ongoing effort to improve access and reduce wait times to fewer than 72 hours boosted outpatient volume, she said. UPMC posted a 13.6% increase in operating revenue in 2006 and a 5.6% operating margin, according to its financial statements.

Meanwhile, similar efforts for administrative functions have consolidated 90% of the system's billing efforts, said Robert DeMichiei, UPMC's chief financial officer and senior vice president. The system is expected to fully consolidate billing in the next 18 months. Such ongoing efforts allow UPMC to continue to invest and expand as necessary, he said.

"There isn't a one-year story here," said DeMichiei.