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The Effect of COVID-19 on Hospital Financial Health

KaufmanHall

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Hospitals Require a Positive Margin to Serve Their Communities

For any organization, a positive operating margin is essential for long-term survival. Few organizations can maintain themselves for an extended period when total expenses are greater than total revenues.

For hospitals, positive financial margins allow them to invest in new facilities, treatments, and technologies to better care for patients, and to build reserves to meet unexpected expenses or revenue shortfalls.

Before COVID-19

Compared with other industries, healthcare margins typically have been very thin. Even before COVID-19, a number of U.S. hospitals struggled with negative margins—in other words, they were losing money on operations. In fact the median hospital margin was a very modest 3.5%.

This situation has been a serious threat to the future viability of many of America’s hospitals.

The Effect of COVID-19 on Hospital Margins

When the COVID-19 pandemic emerged, hospitals had to stop all but the most urgent non-COVID care. The result was a dramatic slowdown in volume of patients and in revenue, while expenses remained high. To date, no one knows when and to what degree these patients will return. The result has been an unprecedented impact and an uncertain future about the ability of hospitals to serve their communities and remain financially viable.

At the request of the American Hospital Association, Kaufman Hall presents our analysis of the critical question of how COVID-19 could affect hospital margins during 2020.

The Path of COVID-19 Remains Unpredictable

This analysis is based on two broad scenarios for the COVID-19 virus.

MORE OPTIMISTIC:
a slow but steady decrease in COVID-19 cases

- This scenario assumes a continued increase in patient confidence and associated return to the hospital setting
- This scenario assumes a higher likelihood of a long slog than a quick return, given current COVID-19 case projections.
- We give this scenario 40% weight in our analysis

LESS OPTIMISTIC:
periodic surges in COVID-19 cases

- This scenario assumes that patient demand will be affected by incremental surges in cases, and by associated government and public health interventions, such as enhancing social distancing requirements or re-enacting stay-to-home orders
- This scenario includes the possibility of both secondary and seasonal surges beginning in the summer and extending through the Fall of 2020.
- We give this scenario 60% weight in our analysis

For more information about our methodology, see page 8.

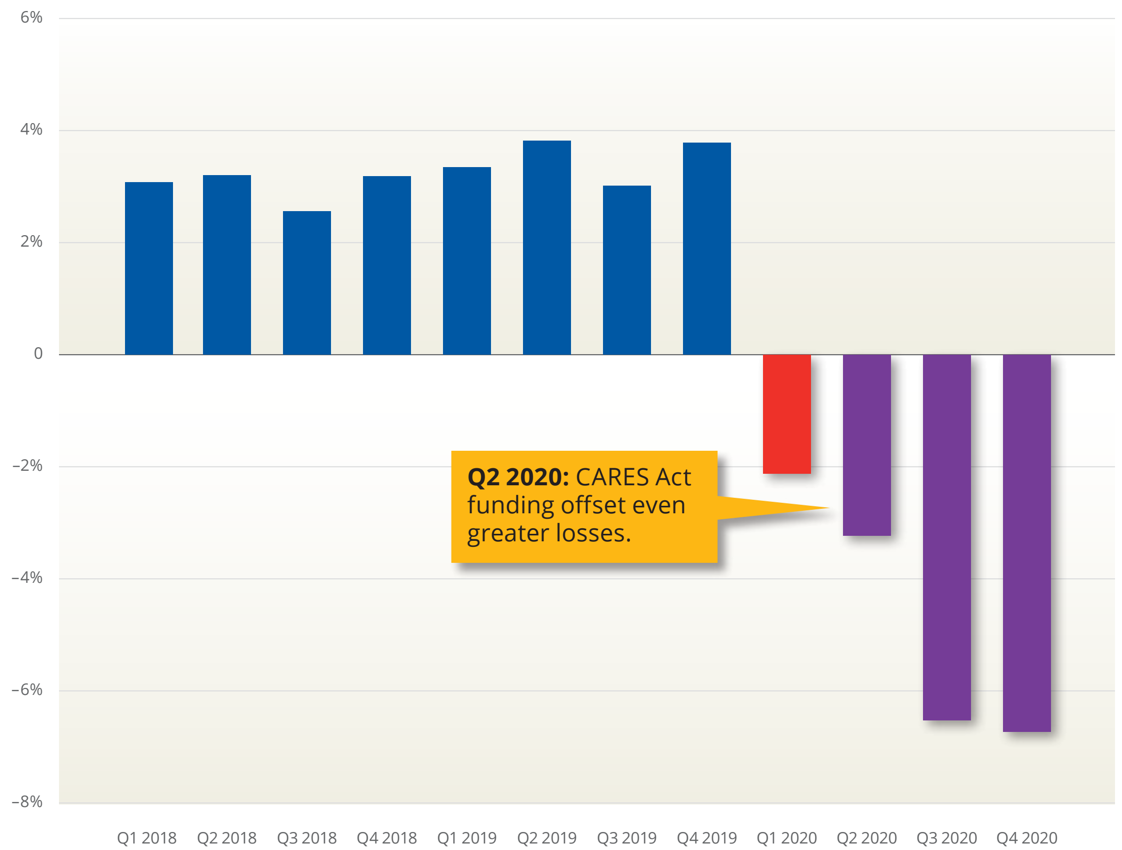
COVID-19 Is Expected to Drive Median Hospital Margins from Positive to Negative

COVID-19 has created immediate and significant damage to hospital margins, as well as great uncertainty about the path forward toward financial stability.

Funding from the CARES Act distributed in April and May—along with estimated distribution in June—is mitigating that impact to a certain degree. Median margins are forecast to drop to –3% in the second quarter of 2020; however, those margins would have been –15% without CARES Act funding.

Our forecast shows that, without further government support, margins could sink to –7% in the second half of 2020. This is an unsustainable level for America's hospitals.

Adjusted Operating Margin Index
Median by Quarter



The Degree of Margin Damage Could Vary Depending on COVID-19's Path

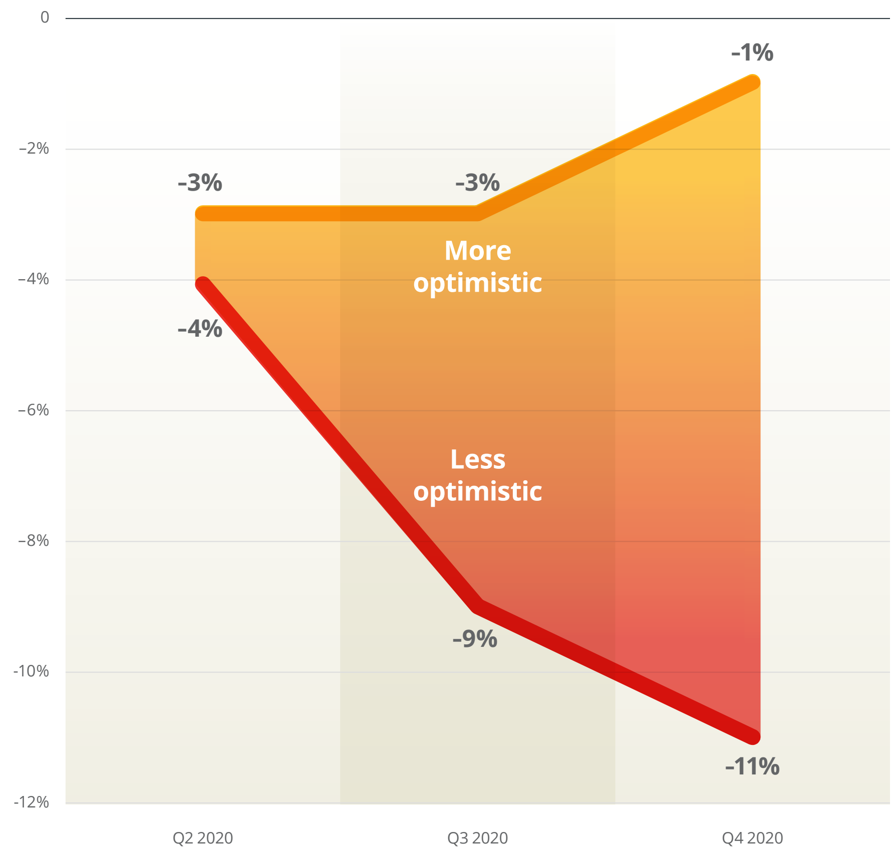
COVID-19's path—whether we see a gradual recovery or new surges—will affect the degree of damage to hospital margins for the remainder of 2020 and into the future.

In the most optimistic scenario, median margins could be –1% by the fourth quarter of the year. In a less optimistic scenario, margins could sink to –11%.

Both of the scenarios shown are possible. Both would undermine the ability of hospitals to serve their communities while COVID-19 continues and in the post-COVID-19 environment.

CARES Act funding delayed a more devastating financial impact of COVID-19. However, without further government assistance, the financial picture will quickly worsen, no matter COVID-19's path.

Adjusted Operating Margin Index*
Median by Quarter



* Margins in Q2 are are different points because the two different scenarios are applied to the forecast for June 2020.

COVID-19 Could Leave Half of America's Hospitals With Negative Margins

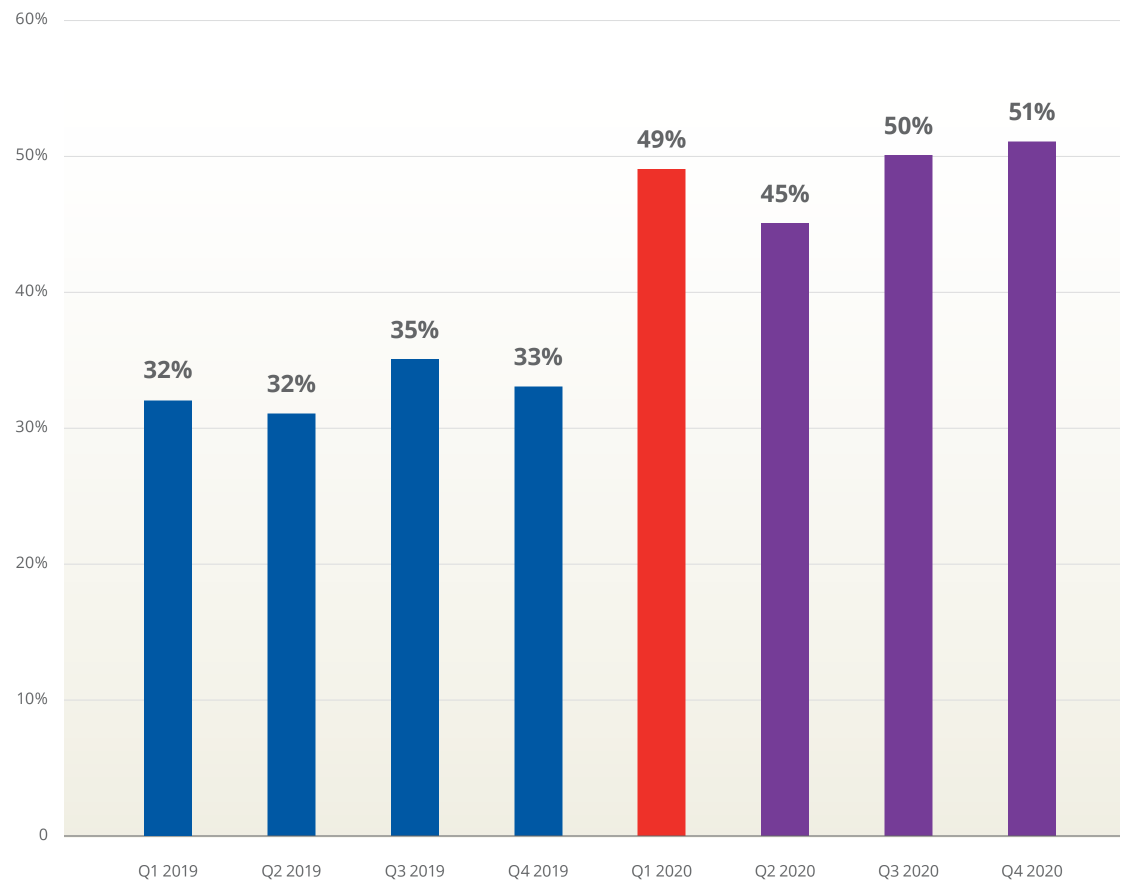
Prior to COVID-19, in 2019, a number of hospitals already had a negative margin—an indicator of the economically fragile state of the industry.

In the second quarter of 2020, when we experienced COVID-19's initial impact, we saw almost half of America's hospitals with negative margins—a figure that was far worse prior to distribution of CARES Act funds.

However, even as COVID-19 recedes, our analysis shows half of America's hospitals will remain with negative margins without any further support.

This is a dire and unsustainable outlook for a major portion of the country's hospitals and communities.

Quarterly % Hospitals with Negative Margin



The Possible Long-Term Impact of COVID-19 on Hospitals

To date, the financial impact of COVID-19 has been significant, even with Federal emergency funding, and the financial damage is likely to continue.

Adding to this financial impact is the unpredictability of COVID-19's trajectory, and the pace and degree of patients' return to hospitals.

In the face of greatly eroded volume and revenue, and a long recovery period, many hospitals are confronted with extremely difficult choices about their paths forward as vital community assets.

Now more than ever, hospitals will need support from governments, and will need to rethink their strategic–financial plans for what is likely to be a highly challenging environment even as COVID-19 cases diminish.

Methodology

Several variables were considered to create projections of hospital operating margins.

Demand

- This is considered the most significant factor and primary driver of margin projection moving forward.
- Kaufman Hall wrote about four potential scenarios for scheduled procedure resumption, including: optimistic, long slog, secondary surge, and seasonal surge – all of these scenarios are considered in the projections, as explained on page 3.
- Surveys indicate a growing proportion of patients are willing to return in the next 3 to 6 months.
- External projections show wide variation in outcomes relative to COVID case modeling, hospital bed demand, and pace of secondary surges.

Expenses and CARES Act Impact

- Response varies across hospitals with regard to labor and non-labor expense categories; many hospitals have significant fixed and de facto fixed cost structures.
- For projection purposes, we assume organizations will continue to manage expenses in a similarly prudent fashion as during the initial onset of COVID from March to May of 2020. Further analysis in this area is warranted and ongoing.
- We include the offsetting impact of CARES funds received to-date in April & May, along with an estimated offsetting impact for June.

COVID-19 Margin Impact

- Margin impacts from COVID-19 have been broadly similar across geographies, hospital sizes, and other variables such as case mix index and inpatient/outpatient revenue mix
- For projection purposes at a national level, we assume these generalized trends will continue.

About Kaufman Hall

For more than 30 years, Kaufman Hall has been providing organizations in Healthcare, Higher Education, and Financial Institutions with independent, objective insight and financially-centered software tools that support decision making and enable the development and execution of sustainable strategies and goals.

Kaufman Hall currently provides consulting services and software to 80 of the 100 largest health systems in the United States.

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