STROUDWATER

Strategic Options Analyses: Having Difficult Conversations Before It's Too Late

It is one of the great ironies of strategy development. When one has fought hard and well to achieve a position of relative strength and market dominance, it can be very difficult to ask the tough questions or to suggest planning for adverse outcomes or seemingly remote threats. Kodak, Blockbuster, and Digital Equipment all dominated their respective industries, but failed to heed the consequences of disruptive innovation. Complacency and a failure of imagination are real dangers for hospital and health system boards just as they have proven to be for these companies and for those navigating the northern Atlantic in unsinkable ships.

One of the common regrets we hear from Board members when we perform a strategic options assessment is: *"I wish we had started this process two or three years earlier."* The organizations where we hear this kind of regret often have certain similarities:

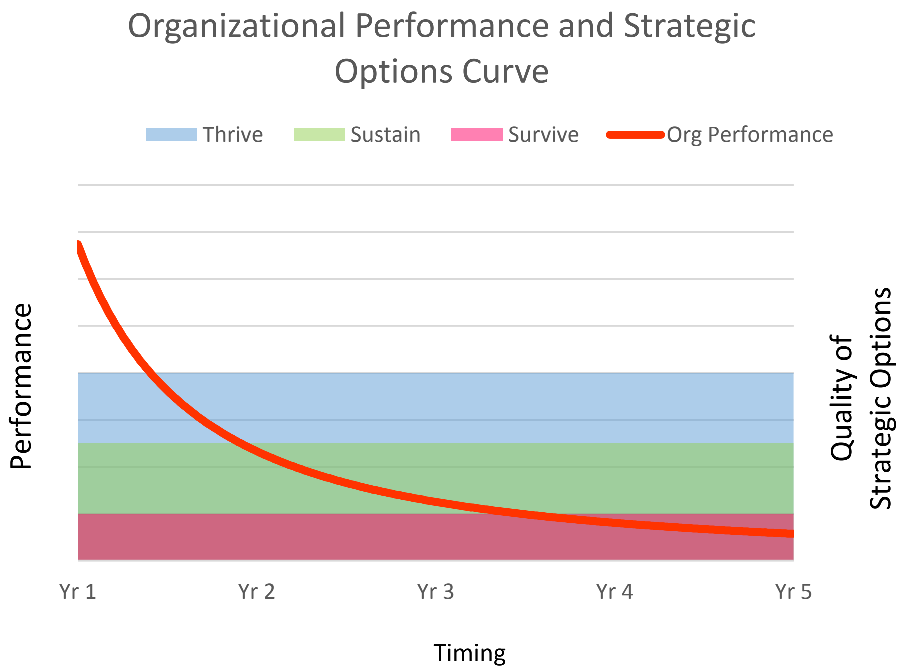
- A long, proud tradition of success and independence;
- Fundamental changes to the local economy, competitive environment and healthcare industry combine to erode the organization's market position and capabilities, and;
- A growing but belated realization that the future trajectory of the local health system is quite different from what had been widely assumed.

A strategic options assessment can be a timely and powerful approach to help hospital and health system leaders evaluate past, current, and future performance against a set of organization- specific strategic objectives and related metrics, ensuring that difficult questions are asked and the risks and rewards of alternative strategic options are explored. A strategic options assessment can ensure that the current strategic direction has been appropriately vetted and that alternative strategic options receive timely consideration or reconsideration in the future, should results be at variance from targeted performance.

Developing a common fact base for understanding the historical and current position of the organization, as well as a set of strategic objectives to guide future decision-making, can be essential tools to providing new insights and forging consensus on future direction where none may exist currently.

Timing

We are often asked when is the right time to assess strategic options or to reassess current strategy. We have two answers to this question. If everyone around the board table agrees that the current strategic direction is unsustainable or has failed, you have waited too long. Prolonged inaction or subpar performance will diminish the quality and number of strategic options available.. Simply stated, the best time to assess your strategic options is from a position of relative strength.

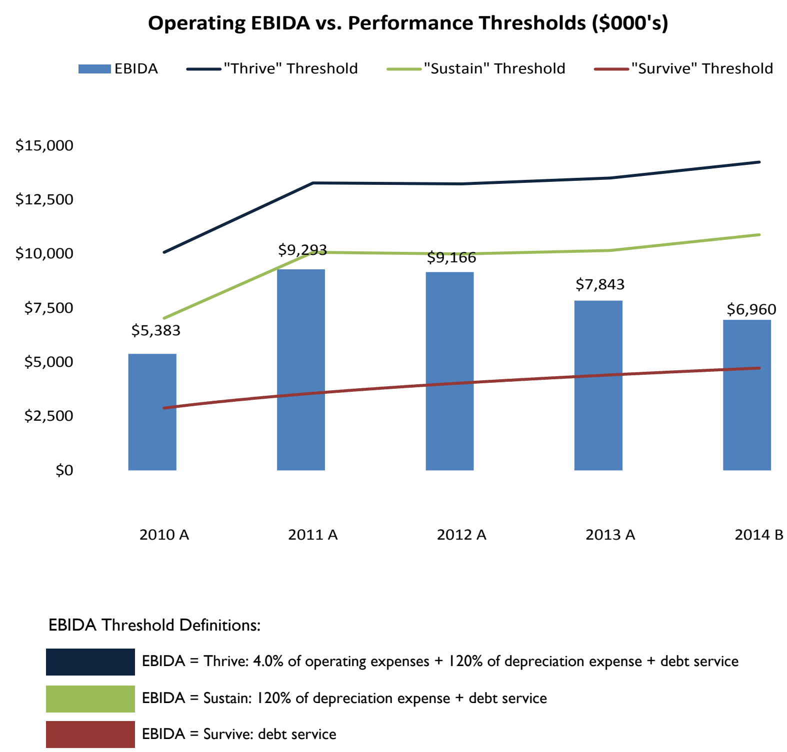


One way to avoid a prolonged degradation of performance and the resulting erosion of strategic options – without taking appropriate action - is to revisit key assumptions, gather objective information and evaluate the organization's strategic position and performance against a set of strategic objectives and associated metrics that define and quantify a vision for what the organization wants to achieve. This discipline will help to avoid the common regret, "I wish we had asked done this two or three years sooner."

The Strategic Options Assessment

The most basic goal of the strategic options assessment is to require the organization to pursue evidence-based strategy. Said differently, an evaluation of current strategy and strategic options should be based upon objective information, not emotion or long-held opinions. At a minimum, it is essential that senior leadership and the Board have a common set of facts on which to base decisions. Hospital and health system leaders often see only snapshot reports that depict current hospital performance with a comparison to prior year or budgeted performance. Such a presentation of operating results does not lend itself to strategic insight. Presenting information with a strategic and historic context can provide the insight to challenge assumptions that are no longer valid.

Our experience has shown that even the most charged set of issues can be examined and discussed rationally when high quality information, analyses and findings are shared with decision makers. The most dogmatic of Board members can be engaged constructively around sound facts and analyses. The chart below is an example of one of the most consistently powerful analyses we perform in these assessments. It compares health system operating cash flow against three performance thresholds, defined as “Survive,” “Sustain” and “Thrive.”

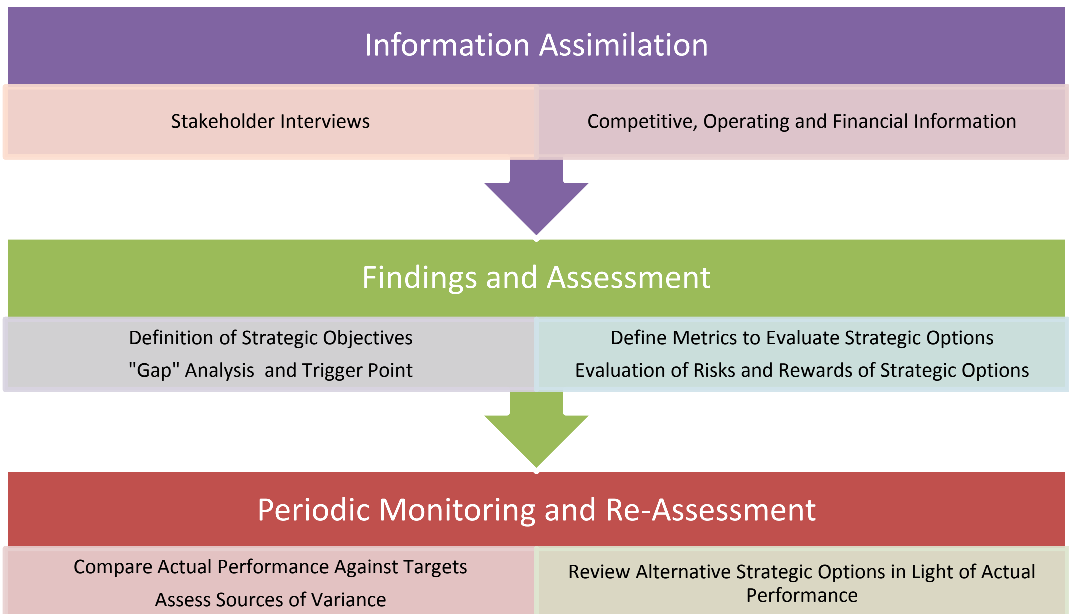


Given the huge investment requirements posed by information technology, physician alignment and other strategic needs, most hospitals and health systems need to perform at or above the “Sustain” threshold to be viable over the long run. If the organization faces significant competitive pressures or has a weak balance sheet, the need for high levels of operating performance increases. In the above analysis, operating cash flows were progressively falling short of the performance needed to position the organization effectively. A comparison to prior year or budgeted performance simply does not provide most Board members adequate insight to assess the overall direction of the organization. The above chart has been designed to stimulate discussions around long-term viability and to lead to deeper analysis and review of the opportunities, risks, and obstacles of current strategy and alternative strategic options.

Defining Strategic Objectives

To define an organization’s strategy, it is critical to define the strategic objectives that collectively describe where the organization wants to go and what it wants to achieve. Once those objectives are defined, it is also possible to evaluate alternative strategic options by how well they will achieve the objectives. The Strategic Options Assessment uses two sets of informational inputs to define the strategic objectives of the organization:

- Stakeholder interviews with Board members, providers, management and sometimes community members, and;
- Analyses and findings drawn from market, competitive, clinical, financial and operating information.



In addition to providing a basis on which leadership can evaluate current strategy and alternative options, the strategic objectives also provide the framework for developing a set of metrics to evaluate how well the organization is executing its future chosen strategy.

Sample Metrics

- Operating EBIDA
- Recruitment and retention of providers
  - Provider productivity on appropriate metrics for payment incentives
- Market share
- Value scores
  - Cost
  - Quality
  - Patient satisfaction
- Covered lives or PMPM revenue growth
- Performance against budgeted population health targets
- Employee and provider engagement and satisfaction

Strategic Direction and Accountability

It is important that all parties to the strategic options assessment acknowledge that no strategic option will be risk free. Unfortunately, leadership will need to choose the option that, in their judgment, presents the best tradeoff between risk and reward when judged against the organization's strategic objectives, constraints and needs. In today's environment, this often means evaluating the tradeoffs of pursuing an independent strategy as opposed to an affiliation strategy. Regardless of which option are chosen, it is critical that the Board, in its fiduciary role, periodically evaluate the chosen direction for how well it is meeting the organization's strategic objectives.

If the hospital or health system is pursuing an independent strategy, the Board should evaluate performance against the strategic objectives and associated metrics at least annually. If there is a variance between the performance required to sustain the organization as an independent entity and actual results, then leadership should take corrective action. If the "gap" in performance is not eliminated, the Board should reassess its chosen strategic direction. This approach ensures that the organization's strategic vision and objectives are not irreversibly compromised by prolonged sub-par operating results.

We collectively refer to the above set of risks as execution risk - whether the organization can effectively execute its strategy. Ongoing monitoring of performance can help mitigate the extent of execution risk. However, if the organization has a weak balance sheet or a compromised market position, monitoring performance relative to targets may not provide enough advance warning before strategic options begin to erode. In such cases, it can be prudent to examine the risks and rewards of an affiliation as a possibility for achieving the organization's strategic objectives.

If the organization decides to pursue an affiliation strategy, it is important to note that this option poses its own set of risks that we categorize as partner risk. Contractually enforceable commitments, selection of a partner with appropriate strategic alignment, the choice of affiliation structure matched to the needs and constraints of the organization and careful examination of the partner's track record, can help mitigate—but not eliminate–partner risk. Notably, the strategic objectives can be used to shape the affiliation process by providing the basis for a request for proposal to be sent to potential partners and the criteria by which competing affiliation proposals, structures and partners may be evaluated. The affiliation process should include several milestones when affiliation options are assessed by how well they satisfy the strategic objectives: i) each round of proposal reviews; ii) selection of semi-finalist, finalist and a preferred partner with whom to negotiate a Memorandum of Understanding (MOU); iii) Board approval of an MOU, and; iv) Board approval of definitive agreements.

Benefits of a Strategic Options Assessment

An organization can benefit from a Strategic Options Assessment in the following ways:

- Organization leadership works from a common, credible fact base that is crafted to provide strategic insight
- Interviews with key stakeholders provide an opportunity to gather their perspectives and engage them to effectively address organizational needs and constraints
- The organization gets to define its strategic objectives, and then view alternative strategies and options through the lens of the strategic objectives
- Developing "triggers" to provide a mechanism to evaluate current strategy and the chosen future strategy, create accountability that reduces execution risk and partner risk, as appropriate
- Historically taboo subjects, such as affiliations, can be discussed in terms of the organization's strategic objectives, aspirations, needs and constraints
- Consensus is developed among leadership and stakeholders regarding a preferred strategic direction, strategic objectives and the mechanisms for evaluating future performance

Stroudwater designs solutions for healthcare leaders' most pressing challenges. Founded in 1985, we are a national advisory firm serving exclusively healthcare clients, and we are proud to have friends and clients in all 50 states. We employ thought leadership and focused analytics in a collaborative process that engages our clients and enables their transformation. Our practice areas are highly focused on the mission-critical strategic, operational, and financial areas where our perspective offers the highest value. Our solutions are client-driven and client-focused. Instead of selling a product or offering a prepackaged solution, we are your trusted advisors on the journey of discovering the unique solution for each client need.

With a team comprised of clinicians, managers, corporate officers, investment bankers, financial analysts, and other experts, Stroudwater is recognized nationally in markets from rural to community hospitals, healthcare systems, and large physician groups. We believe this type of broad understanding and experience with all the elements of the delivery system critical for serving clients in an increasingly interconnected and interdependent environment. In this context, our practice areas are focused on:

- Affiliations and partnerships
- Strategic planning and operational improvement
- Population health
- Strategic master facility planning
- Physician-hospital alignment
- Capital planning and access
- Revenue cycle

Jeff Sommer, Director
jsommer@stroudwater.com
O: 207-772-8855

Rob Kirsch, Managing Director
rkirsch@stroudwater.com
O: 770-913-9215

50 Sewall St. Suite 102
Portland, ME 04102
www.stroudwater.com