KaufmanHall

May 26, 2022

Aligning Real Estate Within the Context of Strategy, Operations, and Finance

Brent Farrell and David Ratliff

Emerging from the pandemic, health systems face a changing landscape and new demands on resources, which include:

- ***Historic wage and supply inflation,*** compounded by staffing shortages and heightened demand for contract labor, has created a sharp and likely permanent increase in operating expenses.
- ***Significant investment portfolio losses,*** which mount as the Federal Reserve tightens monetary policy to address inflation, will threaten the balance sheet's role as a buffer against operational volatility.
- ***Strategic shifts as the migration of services from inpatient settings*** reshapes competitive dynamics in many markets will require new investments in outpatient facilities and digital health platforms that support consumerism, telehealth, remote monitoring, and other care delivery models.
- ***An imperative to address health inequities*** among socioeconomic groups will demand new and targeted interventions to improve access and outcomes.

In this environment, disciplined resource management is critical. Kaufman Hall continues to promote a decision platform called Strategic Resource Allocation (SRA) that connects strategy, operations, capital, investments, and debt under a unifying framework. SRA allows an organization to understand the interdependencies between these topics and therefore better manage its aggregate risks and resources.

We often find that real estate has not been integrated into a health system's total resource strategy, even though it is one of the most significant resources a health system possesses. Leadership must determine both how its real estate portfolio does (or does not) support its strategic objectives, operational needs, and financial commitments, and how that portfolio might be realigned to better support the organization. That determination will depend on a two-step process:

Leadership must determine both how its real estate portfolio does (or does not) support its strategic objectives, operational needs, and financial commitments, and how that portfolio might be realigned to better support the organization.

1. Develop an understanding of your real estate needs
2. Catalog resources to unlock the value within the real estate portfolio

Step 1. Develop an understanding of your real estate needs

This is harder than it sounds. A health system's current and future space needs—and the real estate portfolio needed to support them—will be affected by a variety of factors, including new care models, technological advances, consumer preferences, physician practices, and organizational strategies. There are, however, some common considerations that can help define those needs.

- ***Inpatient facilities.*** As more care is delivered beyond a hospital's walls, and even at home, the question of current and future inpatient space needs merits careful consideration. After the Omicron variant surge passed early in 2022, nationwide occupancy rates returned to around 60% of total bed capacity, according to American Hospital Association data.[1] There will be significant local variations in this nationwide percentage, but for organizations that are in mature, slow-growth markets,

[1] The American Hospital Association's COVID-19 Bed Occupancy Projection Tool estimated that as of April 29, 2022, 60% of the 924,107 hospital beds in the U.S. were occupied. https://www.aha.org/statistics/fast-facts-us-hospitals

there already may be too much inpatient capacity. Even in growing markets, the need for inpatient capacity will continue to be pressured by the continuing migration of care to outpatient, virtual, and at-home settings and to specialty facilities, including inpatient rehabilitation facilities (IRFs) and behavioral health hospitals. Planning efforts should include frank assessments of how much inpatient capacity will be required five to 10 years in the future. Even if adequate capacity exists for current or future needs, planning may need to account for replacement or renovation of an aging or outdated facility.

- ***Beyond inpatient facilities.*** Most health systems have extensive real estate holdings beyond their inpatient facilities—including medical office buildings, administrative office buildings, urgent care facilities, outpatient surgery centers, and even raw land—that should be counted in an evaluation of system resources. With respect to these assets, questions include utilization and local market trends. Have post-pandemic changes in work patterns affected utilization of administrative buildings? Are medical office buildings being fully utilized for the purposes for which they were intended? Are specialty facilities (e.g., behavioral health hospitals, freestanding emergency rooms, IRFs) being constructed or redeveloped in the market, and by whom?

Step 2. Catalog resources to unlock the value within the real estate portfolio

The next step is to fully understand exactly what you have, and whether your portfolio is capable of adapting to the changing needs of the healthcare industry. Health system leaders should consider undertaking a full inventory, use planning, and valuation of the system's full real estate portfolio, including both owned and leased assets. This will allow you to understand where and how much potential value is located within the real estate portfolio as a whole. Of that total, certain of the assets will be more essential to the organization's overall mission, strategy, and projected needs and so deemed to be less liquid on the balance sheet; conversely, other real estate assets may be found less essential to the organization's future, and therefore, potentially more liquid. The goal of the exercise is to ascertain the organization's true needs, thereby allowing management to re-task, liquidate, or otherwise optimize less essential real estate. Monetizing non-essential assets may better position the organization to redeploy those resources in a better overall manner for the organization.

Certain assets will be more essential to the organization's overall mission, strategy, and projected needs and so deemed to be less liquid on the balance sheet; conversely, other real estate assets may be found less essential to the organization's future, and therefore, potentially more liquid.

After this analysis, if leadership determines there truly is or will be excess capacity within the real estate portfolio, it can begin making decisions on:

- The time available to unwind holdings that are misaligned with current or future needs
- The options available for monetizing or repurposing misaligned assets
- How any value unlocked from misaligned assets could be redeployed within the organization

Conclusion: Optimize the use of total resources

Aligning real estate with strategy, operations, and finance connects what can otherwise be viewed as siloed assets within health systems. Bringing real estate into an integrated conversation involving all the system's stakeholders will ensure that it can serve to meet the organization's needs well into the future.

For more information, please contact Brent Farrell (bfarrell@kaufmanhall.com) about real estate questions or David Ratliff (dratliff@kaufmanhall.com) about Strategic Resource Allocation.