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## Capital Allocation and Planning for a Stabilizing Healthcare Outlook

The post-COVID period brought unprecedented challenges to the healthcare sector, as economic pressures, structural shifts, and regulatory pressures resulted in declining financial performance. More recently, health system performance has begun to stabilize, as reflected in [recent Kaufman Hall National Hospital Flash Reports](#) finding financial and operational improvements through November 2024.

At the same time, the new level of industry-wide health system operating cash flow performance has raised questions regarding long-term sustainability, and the range of performance is wide: the bottom two thirds of providers are experiencing stagnating or declining performance. In addition to providers with acute financial challenges and capacity constraints, systems with recent substantial growth and consolidation may need to revisit their capital process accordingly. Furthermore, systems that are currently investing in significant opportunities to extend their market advantage and strategic positioning may need a more structured way to prioritize growth.

Regardless of their current performance and financial position, organizations that actively maintain a best-practice capital allocation and management process can accommodate the demands of the current, dynamic healthcare environment—from inflationary pressures to shifting sites of care—through application of an established, structured, and disciplined data-driven approach. A capital process rooted in these fundamentals should be flexible to address changing healthcare environment, new strategic priorities, and a new reality.

### Mounting Capital Needs Require Strategic Prioritization

Hospitals face a growing list of capital needs—many of which were deferred during the pandemic and its inflationary aftermath. These include addressing deferred maintenance, enhancing high-margin service lines,



improving access, and investing in technologies to stay competitive. Key themes include:

1. *Addressing delayed capital projects:* Many projects postponed during COVID must now be addressed to continue to provide healthcare services to the community despite inflation-driven cost escalation for these projects.
2. *Prioritizing high-performing service lines:* To improve financial performance, hospitals are focusing on service lines such as cardiovascular, oncology, orthopedics, and neurology/spine services. While these service lines may offer high returns, they often face stiff competition and require significant capital investment.
3. *Shifting outpatient services:* The shift towards outpatient care has increased investment in providers' ambulatory platforms (e.g., ambulatory surgery centers).
4. *Investing in technology:* Upgrading electronic medical record (EMR) and patient engagement tools is critical to remain competitive, provide quality care, and improve efficiency.
5. *Balancing system versus local capital needs:* Industry consolidation and growth has led many leading organizations to shift from a single-market to a systemwide, multi-market perspective. The organization's capital process should support such a system-level view when prioritizing and allocating capital.

## Understanding the Fundamentals of Capital Planning and Allocation

Capital planning and allocation decisions have always been best made within the context of an integrated strategic and financial plan. A well-defined and collaborative strategic vision should serve as the foundation for capital-related decisions.

While every capital allocation and management process incorporates organization-based, unique components that drive how capital should be allocated among competing priorities, successful processes are founded on certain, consistent fundamentals. The effectiveness of an organization's capital allocation process is rooted in the rigor of analytics that support decision making, the discipline of the organization to stay within the process structure, and the nimbleness of the process structure to adapt to industry conditions. An effective process incorporates the following fundamentals:

### **Structure**

The organization's process for allocating and managing capital should flow directly from its integrated strategic and financial planning. This creates a direct linkage between strategically required operating cash flow and cash available for capital. In addition, and certainly as important, the direct connection ensures that identified capital projects align with the strategic plan. In this way, decisions regarding application of the organization's limited capital resources can be made not only within the context of its available capital capacity, but in a manner that is consistent with its identified strategic direction and priorities.

This process integration relates to the context of both specific decisions and the chronology of decision-making. A basic aspect of a best-practice capital process is that it flows from the parameters of established strategic and financial planning.

Lesli McGee, Chief Strategy Officer for South Carolina-based McLeod Health, says the seven-hospital system took steps to align its planning and capital allocation processes systemwide, taking into consideration everything from facility maintenance needs to potential new business lines.

Organizations that actively maintain a best-practice capital allocation and management process can accommodate the demands of the current, dynamic healthcare environment.

"Our new process allows visibility both horizontally and vertically—across the health system—to make sure we're making solid business decisions that allow us to support the capital needs of the entire system," McGee says. "The new capital management process crossed the chasms between hospital operations, strategic planning, and financial planning for true alignment."

### **Rigor**

Data-based assumptions and business planning analytics form the backbone of an effective capital allocation process. While aspects of the underlying integrated strategic and financial plan may change to meet changes in the market and industry, the rigor of the analytics supporting alternative initiatives must be maintained to support informed decision-making.

Kirsten Largent, CFO at OSF HealthCare, a 17-hospital system based in Illinois, notes that OSF has formalized a retrospective "lookback" process to measure how projects perform against their initial assumptions.

"It's also tuned up the accuracy of our proforma requests," Largent says. "Our leaders know that projects will be going through a lookback process and will need to report on the performance against the assumptions that were included in the proforma."

### **Discipline**

A key to successful capital allocation decision-making is the ability of management to stay within the defined process. Regardless of disruption to the environment, this discipline will ensure continued integration of strategic, financial, and operating plans. As a result, the organization will be able to balance strategic opportunities with financial capabilities and ensure that capital is deployed to meet the organization's adjusted needs without weakening its financial integrity.

Lesli McGee of McLeod says the system redesigned its capital management process to create a more structured planning approach, which was rolled out to the team with careful change management-focused training.

“The key to successful implementation is having somebody on your team that can really lobby for the new process and that understands the change management steps between your old and new programs,” McGee says. “It’s important to manage the change in baby steps but keep the focus on what’s next to keep the momentum going. Especially as we had been using the old system for decades, we had to recognize how big the change lift was for the team in order to help it be successful.”

Largent noted that employing a capital management council for governance, with leaders from across the organization vetting projects together, has helped ensure alignment at OSF. System leaders have been pleased with the approach.

“It was good for our board and executive team to see the intersection and consistency between the planning efforts,” Largent says.

### **Nimbleness**

To be fully effective, the process must allow organizations to take advantage of opportunities outside of the annual capital cycle while also requiring rigor and discipline for all capital projects (e.g., creation of a business plan, review, and approval by centralized governance committee).

Largent notes that OSF employs a system contingency fund—which comprises approximately 10% of its total capital constraint (i.e., its cash flow available for capital)—to manage capital requests outside of the annual capital cycle. OSF has also standardized out of cycle capital requests to align with the overall capital allocation process. “The biggest change to the process concerns the out of cycle requests,” Largent says. “We’ve always been really good about gathering all the information for the

annual capital allocation process. But when that strategic opportunity came up mid-year, we didn’t have a formal process for vetting them. The new process has helped us be more nimble in getting the right projects approved.”

The standardization effort has also simplified the process for requests, Largent notes.

“Leaders know exactly what to do if they have an out of cycle or annual capital request.”

### **Closing thoughts**

As hospitals and health systems respond to the challenges and opportunities of a stabilizing but still challenged market environment, their strategic and financial plans will inevitably change. The current environment requires these organizations to make difficult choices about where to apply their precious and limited capital resources. In addition, as organizations grow and evolve, it may necessitate them to re-assess their current capital processes and refine them consistent with their strategic direction. A rigorous capital allocation process provides a structured, data-driven approach to navigate these challenges. While some projects may lack a straightforward return on investment, an effective capital process enables organizations to balance financial, strategic and patient care considerations effectively.

It is important that leadership teams focus on safety, quality, and strategic priorities in addition to financial targets, and there may be individual initiatives that do not meet the organization’s target ROI thresholds. However, only within the rigor and discipline of a well-designed capital allocation and management process can hospital leaders ensure that the aggregate portfolio of capital investments will contribute to the organization’s long-term financial sustainability while improving patient care within their communities. In this era of uncertainty, disciplined capital planning is not just a necessity—it’s a pathway to organizational resilience and growth.

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