CHAPTER 1

Capital Allocation and Management Essentials

This chapter identifies types of capital resources covered by the capital allocation and management process, defines that process, and describes its significance. The chapter provides details on the decision-making flow or cycle for capital allocation and management, and it outlines the traditional and best-practice approaches to developing and managing the process.

THE NEW DEFINITION OF CAPITAL

A corporate finance approach to capital allocation and management is based on a contemporary, evolving definition of *capital*. This definition extends beyond traditional capital items, such as property, plant, and equipment, to embrace virtually all calls on an organization's cash flow. Essentially everything that might appear on the cash flow statement, including such items as working capital for investment start-ups, joint venture and physician practice investments, health plan investments and reserves required under risk-bearing arrangements, and all other items that take cash out of the organization, should be considered capital uses.

The traditional definition of capital, which focuses only on depreciable assets, is far too narrow to support truly strategic capital management. A broad definition of capital must be accepted as part of the basic structure of the capital allocation and management process because of the breadth of sources for capital deployed through the process and the variety of related capital uses. Exhibit 1.1 provides a comprehensive list of the capital investments that should be subject to the formal allocation and management process. The identified range of investments could as easily apply to a typical community hospital as to a multihospital health system or academic medical center.

Exhibit 1.1 Investments Covered by the Capital Allocation and Management Process

- Facilities, property, and equipment, including information technology
- Business acquisitions and partnerships
- Divestitures and asset monetization
- Equity investments
- Network development
- Managed care investments
- New operating entities, programs, and services
- Program start-up subsidies or expansion
- Physician integration, recruitment, practice purchase, partnership, and other arrangements
- Organization-level (or system) initiatives
- Nontraditional investments, such as post-acute care services

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Applying this broadened definition of capital investments that should be subject to the allocation and capital management process is critical as organizations focus strategic investment away from capacity and toward efficiency and appropriate levels of care. In addition, as discussed in chapter 3, the definition of capital must hold true regardless of the anticipated source of funding for that investment (including leases and philanthropy).

In not-for-profit organizations, capital resources apportioned through the comprehensive capital allocation and management process come from three sources: cash flow from operations, philanthropy, and external debt. Chapter 3 describes these resources in detail.

CAPITAL ALLOCATION AND MANAGEMENT DEFINED

Capital allocation is the strategic process organizations use to make capital investment decisions. Through this process, healthcare executives determine how much capital will be spent and where the organization's scarce capital resources, including cash and debt capacity, will be deployed.

A best-practice *capital allocation and management* process ensures that the organization spends the optimal amount of capital—not too much and not too little.

It also ensures that investment is made in a portfolio of initiatives that provides a positive contribution to the organization's strategic and financial positions.

The capital allocation and management process is not capital budgeting. Exhibit 1.2 describes how the capital budgeting process differs in content and context from the capital allocation and management process.

In contrast to capital budgeting, the capital allocation and management process is comprehensive, with a broad purview over all calls on an organization's cash (listed in exhibit 1.1). The success of the capital allocation and management process is directly tied to the organization's strategic and financial performance. Available dollars are identified on the basis of the organization's long-term strategic and financial vision. Approved allocations of capital are expected to create an overall portfolio that will generate an optimal return over a multiyear period.

Capital allocation and management comprehensively considers the short-term and long-term implications of each potential investment within an overall portfolio of investments. Its focus often extends over three to five years and even beyond—in the case of facility development or the development of new programs, services, or affiliations, for example. The detailed analysis (i.e., business plan) supporting each capital investment proposal provides transparency that enables executives to identify and track key accountabilities, opportunities, risks, and alternative outcomes. A well-devised business plan anticipates potential problems related to individual project or portfolio performance. Problems that do occur can be corrected as they arise, or, in the worst case, exit strategies previously defined in the business plan can be implemented before strategic and financial performance is materially and negatively affected.

Exhibit 1.2 How Capital Budgeting Differs from Capital Allocation

Capital budgeting is the administrative process organizations use to identify and spend "routine" capital that has been allocated. It represents a small piece of the comprehensive capital allocation and management process, typically relating only to minor expenditures that fall under department managers' purview. Larger, more complex capital projects (often designated as "strategic") tend to be reviewed and approved outside the standard capital budgeting process in a planning process managed by a separate set of management players. Capital budgeting has a one-year focus. It is an administratively driven process whose success is measured by such criteria as "time required for completion" and "variance of expenses from budget."

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THE SIGNIFICANCE OF CAPITAL ALLOCATION AND MANAGEMENT

The most important financial decisions made each year by an organization's senior management and ratified by its board relate to how much capital to invest and on which projects and initiatives those dollars will be spent. The long-term success of a healthcare organization depends on the capital investment decisions it makes today. Every decision either increases or decreases organizational value. Investments that protect or improve the organization's net cash flow stream by supporting successful strategies must be part of the long-term strategic and financial plan.

Organizations cannot shrink their way to success. Leadership must act on the knowledge that investments to create ongoing growth are the foundation for the organization's future. Decisions to invest capital must increase organizational value—the organization's ability to generate capital for future investment in known or yet-to-be-defined strategies, maintain or improve its creditworthiness, and accomplish its mission. For every investment that does not generate value (e.g., mission- or community-directed projects), the organization must seek other ways to create equivalent cash flow and value to develop a balanced portfolio. The cumulative effect of incremental decisions determines the organization's overall success. Exhibit 1.3 describes the new view of requirements to achieve growth and scale under healthcare's transforming business model.

High-performing organizations place a high priority on the formal allocation of capital because they understand that existing capital capacity, defined as the amount of debt- and cash flow–based capital an organization can generate and support, is a function of past performance. The creation and regeneration of capital capacity depend on the organization's continuing ability to make value-adding investment decisions.

New sources of cash flow are increasingly hard to find. In an environment of constrained payment, scarce resources, and increased competition, the cost of making bad capital investment decisions can be severe. Uninformed or poorly analyzed decisions can have financial and market effects that emerge only three, five, or even ten years later. Such decisions reduce the organization's capital capacity, limiting its ability to pursue future initiatives, and in turn, reducing its ability to achieve or maintain competitive market strength.

The safety net provided in the past by Medicare and Medicaid cost reimbursement and generous indemnity insurance structures no longer exists. Credit market requirements have tightened, demand for new business model investments has increased, and healthcare's operating cash flow and access to affordable capital are constantly challenged. To survive and succeed in the current environment,

Exhibit 1.3 The New View of Growth Under a Value-Based Business Model

Under the fee-for-service business model, *volume* for hospitals and health systems is defined by the number of discrete services provided to patients. Providing more services yields more revenue for hospitals and health systems because insurers reimburse for each service delivered to insured patients. In a fee-for-service model, growth strategies typically focus on investment in new facilities that would increase service volume through added capacity.

Under a value-based business model focused on managing population health, organizational growth will be achieved by increasing the number of individuals covered under risk- or value-based contracting arrangements and by covering those individuals cost-effectively on a fixed-revenue-per-covered-life basis. Care may be provided by the organization itself or by a provider in the network managed by the organization.

As healthcare's focus transforms, the goal of an organization also must change to a focus on building market share through its covered population, where the organization must manage operating performance variability under risk-based payment models. Growth strategies under the new business model are moving away from creating capacity to including investment in the right mix of providers, services, and delivery locations that support the right cost of care. The organization's goal is to position itself to remain highly relevant to employers, insurers, and consumers. Business acquisitions, partnerships, and recruiting and investing in physicians are common growth strategies for building such market essentiality.

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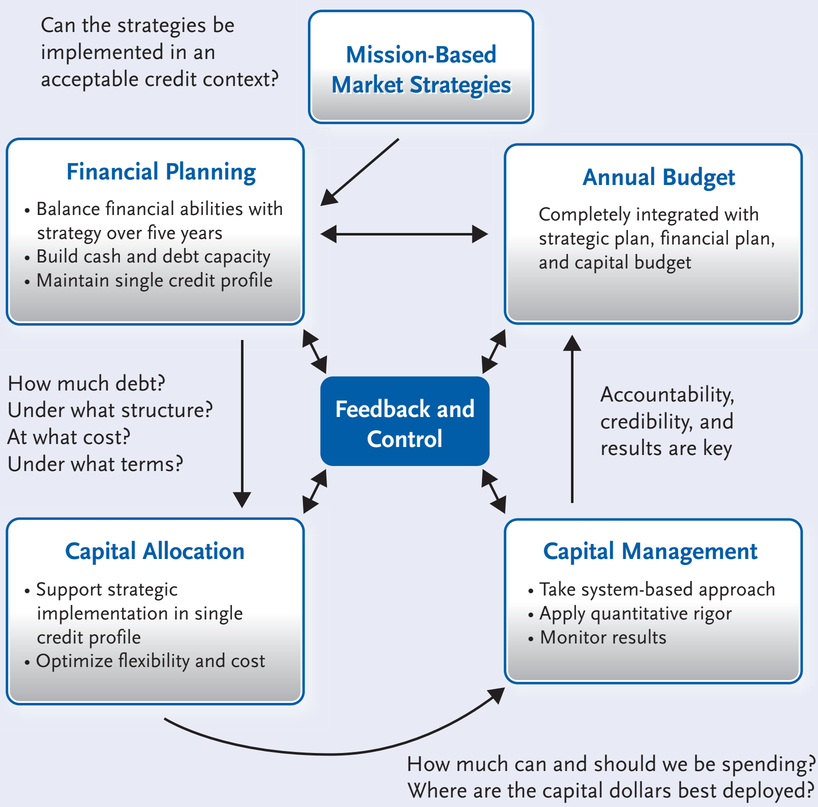
an organization's capital allocation and management process must be based on principles of corporate finance, including the rigorous and consistent application of solid decision-making criteria, proven quantitative techniques, and enhanced transparency.

THE CAPITAL MANAGEMENT CYCLE

The capital allocation and management process is an integral component of the *capital management cycle*—an organic, circular pathway that defines the flow of analysis and decision making related to the management of capital, as shown in exhibit 1.4. A best-practice capital allocation and management process is the linchpin in an organization's ability to capitalize the strategies that it has defined, quantified, and made operational through the capital management cycle. These strategies, which may be both market based and clinically based and both internal and external, include the following:

- Support for the organization's mission- and community-based imperatives
- Strategic investment in existing service line growth or new businesses and ventures
- Ongoing infrastructure investment in the organization's property, plant, and equipment
- Major and long-term investments, such as partnerships and new outpatient, virtual, or other access enhancements
- Maintenance or growth of balance-sheet cash reserves to fund liquidity levels consistent with optimal access to capital

Exhibit 1.4 The Capital Management Cycle



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Embodying the key concepts of a corporate finance–based management philosophy, the capital management cycle starts with the identification, through the *strategic planning process*, of market- and mission-based strategies that require funding. These strategies define the nature of the organization and the initiatives it wants and needs to pursue in the next five to ten years to achieve its objectives.

In the next cycle stage, the *financial planning process*, the organization quantifies the broad capital requirements and potential effects of the defined strategies. The goal of financial planning is to evaluate whether the identified strategies can be implemented within an acceptable credit context. In conjunction with the financial plan, *capital structure management* focuses on optimizing the use of external sources (e.g., debt and philanthropy, where available) to fund the identified strategies in a manner that ensures maximum flexibility and the lowest possible cost of capital.

The prioritization of specific capital investment opportunities is an iterative step in the capital management cycle that occurs through an organization's *capital allocation process*. Capital allocation balances strategic opportunities with financial capabilities. It ensures that capital is deployed to meet the organization's strategic imperatives while enhancing the organization's financial integrity through its portfolio, as described earlier.

The *annual budgeting process*, which creates a current-year implementation and operating plan, integrates the targets of the strategic and financial plans with the specific investment decisions of the capital allocation process. The annual operating budget should be a strategic document that reflects the operating plan for an organization's base business and implementation of selected strategies. It also provides a means to monitor revenue, expenses, and capital on an ongoing basis.

Capital allocation is thus integrally linked with the organization's strategic, financial, and capital planning processes, as well as its annual budgeting process.

The key principle underlying a successful capital management cycle is as follows:

> Financial performance must be sufficient to meet the cash flow requirements of the strategic plan and, at the same time, maintain or improve the financial integrity of the organization in a carefully evaluated credit and risk context. (Kaufman 2006)

Healthcare executives of not-for-profit organizations vary in their awareness and application of this core principle. Executives who fail to see the interconnectedness of strategy, financial planning, and capital allocation are at significant risk of damaging their organizations' financial performance and continued financial integrity.

TRADITIONAL AND EMERGING, YET PROBLEMATIC, APPROACHES TO ALLOCATING CAPITAL

Approaches to allocating capital vary considerably in contemporary healthcare organizations. A brief look at some common and emerging approaches that are *not* best practice nor recommended can be instructive.

First Come, First Served and Political Approaches

Perhaps the most prevalent approach to allocating capital in healthcare is the *first come, first served approach*. In hospitals and health systems that use this approach, specific projects are evaluated in a serial fashion as they arise throughout the calendar year.

Organizations that employ this approach often go to great lengths to calculate the total amount of cash flow available to be spent on capital, which is clearly a best-practice concept. However, as the fiscal year progresses and projects are approved one by one, capital is apportioned against the calculated limit. Inevitably, at some point during the year, a capital request to fund a project or projects capable of bringing significant growth to the organization works its way forward to be approved. Unfortunately, all of the capital may already have been spent, denying (or at best, deferring) funding for a key strategy. The serial nature of initiative evaluation and approval precludes the ability to construct a portfolio of investments with the best overall strategic and financial return. Exhibit 1.5 illustrates how this occurs.

A purely subjective or *political approach* also is problematic. The department, service, or other unit that demands the most gets the most. The trouble is that squeaky wheels with newly applied capital grease do not always bring the best returns. By essentially ignoring quantitative evaluation, this approach assumes that the core business can generate sufficient cash flow on an ongoing basis to support investment initiatives that may not have acceptable returns. Often, this type of process exists in organizations with highly centralized decision making and a culture that uses allocation of capital to reward past behavior or to appease a powerful political constituency.

History-Based and Balanced Scorecard Approaches

Another approach organizations often use is the *history-based allocation approach*, in which capital is allocated the same way it was allocated in the previous year. If a

Exhibit 1.5 The Problem with First Come, First Served Capital Allocation

Suppose that the leaders of an organization have $10 million to allocate to projects during a one-year period. Project A, costing $4 million, is proposed in February, looks good, and is approved. Project B, costing $3 million, is proposed in March, looks acceptable, and is approved. Then Project C arrives in June. It has the best projected return of all three projects and is associated with a key strategic initiative, but it carries a $5 million price tag.

Having already spent $7 million on Projects A and B, the organization simply does not have the funds for Project C. Management is faced with a devil's alternative. Had all three projects been evaluated simultaneously, the leaders would have decided to pursue Projects A and C and to hold off on B. Now the available options are to either forego a strategic opportunity or use precious cash reserves to over-fund capital during the current fiscal year. This situation occurs simply because the business plan for Project C took 60 days longer to prepare than did the plans for Projects A and B.

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hospital's radiology department or a hospital in a multihospital system received $X million or X percent of the total capital dollars this year, it would expect to receive the same (and maybe even an increased number of dollars or a similar percentage) next year. The problem is that in today's rapidly changing healthcare environment, past performance is not always the best predictor of future results, and the focus of past investment may be inconsistent with the organization's current strategic direction.

Some healthcare organizations use a *balanced scorecard approach*, which may evaluate potential investments based on qualitative market and management issues, such as community needs or physician satisfaction. For example, if a proposed project is designed to meet the qualitative goal of enhancing physician satisfaction, the balanced scorecard approach gives it high marks. Often, no quantification is provided.

Corporate finance–based allocation of capital would force the analysis to go a step further and quantify the potential impact of increased satisfaction. Will greater physician satisfaction lead to more effective use of hospital services? If so, what financial impact can be expected? Will ancillary service utilization change, and if so, by what amount? Clearly, the answers to these questions often will be estimates, but even estimates provide the organization with some measure of the investment's potential impact. Qualitative factors must be properly quantified and evaluated within an overall context of performance.

An additional problem with the balanced scorecard approach is its formulaic use of multiple, weighted criteria that essentially codifies the subjectivity of the group responsible for establishing the weightings. For example, if there are ten criteria, it is possible that only 10 percent of the decision weighting would be assigned to financial return—one of the ten criteria. No organization can survive in the long run if it consistently pursues a series of investment decisions that are strategically driven to the detriment of the organization's financial position. Financial return must be weighted more heavily than other criteria, and the portfolio of investments selected must bring a positive return.

Rolling Capital Approach

Some organizations are considering or are using a *rolling capital approach*. This approach attempts to adopt a method successfully used in operating budget management. It is based on the belief that application of regular updates to the organization's operating forecast (e.g., monthly or quarterly) will enable the organization to more nimbly and effectively adjust its capital spending levels and priorities. In its purest form, the rolling capital approach should result in a capital spending plan that would continuously reflect changes in operating performance, new technologies, short-term market reactions, and management priorities.

While this approach can create significant decision-making flexibility, it is not recommended because of its failure to apply key corporate finance principles that are the foundation of the recommended best-practice process, as described later in this chapter and in chapter 2. These key principles include the following:

- **Standardized decision making.** A key component of the rolling capital approach is the aggregation of different types of capital projects into multiple portfolios. For example, project groups might include those focused on financial margins, organizational mission, maintenance, value, cost reduction, and others. Each of these groups is handled differently based on its unique characteristics. This differential handling undermines the organization's ability to provide the standardized decision-making approach that has been shown to be vital to a successful capital allocation process.
- **Project return.** The rolling capital approach applies different return requirements to different project groups based on their intent (e.g., value creation, cost reduction) rather than a common return requirement that is then adjusted for potential risk (see chapter 6). The lack of a common return requirement creates significant opportunity for the process to be manipulated through definition of project types or intent and alternative return requirements. This undermines the integrity of the decision-making process.

- **Portfolio return.** A continuously changing capital spending plan essentially creates serial capital review and approval, which diminishes the organization's ability to understand the potential return on investment of the capital investment portfolio.
- **Corporate-based financing decisions.** The lack of a firm capital portfolio diminishes the ability of the chief financial officer (CFO) to make valid financing decisions. If the portfolio changes, financing structure and cost of capital are affected. A basic tenet of corporate finance is the separation of project and financing decisions. This concept reflects the need to optimize access to capital by matching the organization's approved capital requirements to potential means of financing (i.e., debt versus equity). Furthermore, in the realm of tax-exempt financing, debt must be associated with specific, appropriate capital initiatives with quantified useful lives. If an initiative is altered to reflect a short-term change in priorities, the tax-exempt status of debt issued for the initiative could be materially affected.

As other approaches to capital allocation and management are developed over time, they also should be evaluated relative to current best practices. It is vital to understand whether proposed new approaches embody the key tenets of corporate finance; reflect the reality of capital acquisition and financing in healthcare; and support consistent, standardized, and metrics-based decision making that creates accountability and transparency.

CHARACTERISTICS OF A BEST-PRACTICE PROCESS

The recommended approach to allocating capital in healthcare organizations should be no different than that used by many *Fortune* 500 corporations. A best-practice approach has the following objectives:

- To support the mission and strategic goals of the organization
- To match capital availability to financial performance
- To protect or create capital capacity
- To provide uniform criteria for project evaluation
- To maximize transparency and, therefore, accountability
- To maintain the highest possible bond rating (i.e., optimal access to capital)
- To ensure consistent investment in the highest-performing assets

Structurally, best-practice capital management is founded on the following key elements:

- A high level of governance, education, and communication
- A coordinated calendar and planning cycle
- Direct links to a sound strategic and financial plan
- Clear definitions of available capital and capital expenditures
- Rigorous, quantified, and consistent business planning for each investment opportunity
- A standardized, one-batch review of potential investments
- Consistent application of quantitative analysis using corporate finance–based techniques
- Data-driven and team-based decision making
- Rigorous postapproval project monitoring and measurement

All of these characteristics, which shape the contents of the rest of this book, are evident in leading US hospitals and health systems. In many other organizations, progress is being made and pieces of this best-practice process are in place, but they are not yet fully integrated with the entire process or with the other components of the capital management cycle. In yet other organizations, the problematic approaches described earlier result in varying degrees of dysfunction in the management of the organization's capital process and the results it generates.

An ongoing survey of capital management approaches employed by health systems of varying sizes and locations indicates that most systems have processes with similar characteristics, though with some variations as a result of organizational and cultural characteristics (Sussman 2016). Rigor, discipline, transparency, and standardization are present in all systems that consider their capital allocation and management process to be successful.

Common Challenges

Three significant challenges prevent comprehensive application of important principles and practices related to capital allocation and management:

1. **Overconfidence.** Some executives may believe that because their organization already employs many best-practice components (e.g., use of standardized analytics by designated capital committees to review proposals for individual capital projects), nothing needs to change. However, a best-practice capital

management process requires comprehensive implementation of *all* the key components. Even if an organization generates superior project-based analytics, the annual review and allocation of capital using a single-batch approach, as discussed in chapter 6, is vital. This approach prevents an organization from mistakenly approving a reasonable but mediocre project in the first quarter of the year, only to find itself without capital resources to invest in a more deserving opportunity in the third quarter. Furthermore, in this type of serial approval scenario, the organization cannot know the true value of the total portfolio of capital decisions made on a fiscal-year basis until well after the fact.

2. **Politics and management style.** The management style of some leaders can prevent the development and use of a best-practice process. Some CEOs and CFOs find it easier to make unilateral capital decisions than to deal with the politics of a process. They may not want to involve certain constituencies who have favorite projects. In excluding these stakeholders, however, the leaders exacerbate organizational politics while defining themselves as the lightning rods for other capital decisions that have bad consequences. They do not realize that physicians, patients, board members, community members, department managers, and payers can be effective advocates, not just obstacles.
3. **Perceived financial strength.** An organization's perceived financial strength is perhaps the most pernicious of the three common challenges, especially during times of business model change. Leaders of organizations that have achieved strong performance under a volume-based system may believe that a "bureaucratic" structure for managing capital spending is not needed as the organization moves to a population health, value-based delivery system. This perception, whether the result of overconfidence or lack of focus, leaves many otherwise high-performing organizations vulnerable both strategically and financially. Over several fiscal years, inconsistent capital decisions that are not integrated with an organization's overall strategy can transform a cash-rich entity with a high credit rating into a cash-poor entity with a lower credit rating. The organization will face significant pressure to rebuild its balance sheet while also trying to find dollars to pursue strategic capital needs.

A best-practice approach to capital allocation and management has a framework with four elements: (1) objectives; (2) principles; (3) process governance; and (4) connected, calendar-driven planning and decision making. These four elements are discussed in chapter 2.

IMPLEMENTATION CONSIDERATIONS

Redesigning the capital allocation and management process is a significant change initiative. To achieve an organization's vision, knowing where the journey begins is just as important as knowing where it is going. To understand the organization's starting point, ask the following questions:

- What investments are receiving capital resources in the organization? Are the initiatives receiving resources consistent with the organization's strategies? How has this evolved from traditional areas of focus?
- Which approaches to decision making regarding capital investments have been employed in the organization?
- What, if any, best-practice characteristics are part of the organization's existing capital allocation and management process?
- What challenges might the organization encounter in reevaluating its process?

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