The Increasing Importance of Strategic Capital Planning

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Amid increased uncertainty, strategic capital planning allows hospitals to quantify how much money, regardless of source, their organization needs to achieve its strategic objectives overlaid on financial performance into the future.

Given the general lack of clarity in the 2018 outlook for capital markets—the types of available debt structures, their possible sources, and their cost—hospital finance leaders should remember the phrase “finance is fashion,” which refers to the constantly changing forces that shape a healthcare business’s profitability. Some formulative forces, such as demographic shifts, are predictable. Some forces are abrupt, such as retroactive payment policies. And others, such as new technologies, are upending assumptions.

Regardless, organizations can prepare for capital investment under any circumstance using strategic capital planning—a process that quantifies how much money an organization needs to achieve its strategic objectives, and then identifies when and from what sources those monies are needed and how funding sources should be allocated across projected future financial periods. The result is a five- to 10-year projection with estimated credit strength under various scenarios of debt and equity contributions to help prioritize capital investments. Strategic capital planning allows for the quantification of key elements driving the organization’s future financial outlook and the evaluation of sensitivities to unexpected events. This exercise should produce an accurate projection of capital requirements and when they are needed, and a comparison of these requirements with available funds, debt capacity, and financing options. It allows leaders to assign priorities for allocation of the organization’s capital resources, identify gaps in funding, and streamline the funding process.

Strategic capital planning does not have to be time-consuming and costly– it can be an extension of the annual budgeting process. The process essentially entails the development of a five- to 10-year pro forma, often using Excel and internal resources. The primary objective is to facilitate decision making and prioritization of various initiatives, identify the ability to maintain financial position in the longer term, and understand how much room there is for error. Organizations thus should tailor the intensity and costs of this exercise to their particular needs.

Elements of a Pro Forma

The development of a financial pro forma should include associated financial ratios used in underwriting. Assumptions about the future should be documented because they will help identify the most important factors or “sensitivities” about future financial performance. Key considerations for projecting future growth in expenses and revenues include the following.

Physical resources. Consideration should be given to ongoing and new facility, physical plant, and equipment needs for implementing mission or market-driven opportunities. A list with estimated costs and average resource life is sufficient.

Human resources. It is important to account for additional staff or providers who will be added to expand or start a new initiative, and to consider the “ramp up” time to full capacity. These costs can be ongoing salaries or contract labor and should include expected benefits costs.

Unintended costs. Initiatives that involve a collaboration with another entity, often on implementation of a new program or service, can lead to reduced productivity. For example, the planning of a telestroke program between a tertiary and rural hospital can take time and effort away from providing services. This effect can be modeled as a gradual increase in revenues relative to the increased expenses noted above.

Operational changes. Consideration should be given to whether the initiative will result any efficiency improvements, such as a consolidation of services onto one campus.

Financial resources. The use of existing funds available to the organization should be considered, including unrestricted funds, debt capacity, grants, and fundraising initiatives. This “sensitivity” can help evaluate a project’s affordability and/or impact the organization’s credit profile.

Capital financing options. Consideration of these options should take into account conservative assumptions on the cost of capital, the costs of the financing, and the costs associated with interim financing. Changes in these cost assumptions and the credit profile effect provide sensitivities to evaluate the amount of future debt.

Sensitive assumptions. Factors that could positively or negatively impact an initiative’s financial performance, such as external environmental changes or an inability to execute on part of the initiative (e.g., due to payment changes manifest in contractual allowances), should be listed.

Such a pro forma process has helped organizations by ensuring decisions are based on objective, quantitative evidence and averting those based on subjective opinions. For instance, a hospital that wanted to build a replacement could find that construction costs increased by 10 percent and interest rates increased more than 1 percent during the planning process. But including variables from the beginning of the process would provide a range of project costs and enable choices as the hospital moves forward.

Alternative Approaches

If pressed for time and resources, an alternative to a strategic capital plan is investment in software and/or consulting services to provide a more detailed plan and model, free up internal resources, establish an on-going process, and better prepare the organization for documentation likely needed in the financing process. Available templates and automated tools allow for financial projections, and some can interface with electronic health records. However, purchases should be limited to cost-effective, labor-saving, or appropriately customizable tools that allow models to include the idiosyncrasies of each organization’s payment structure.

The intensiveness of a strategic capital plan will vary depending on the nature of the capital project and the credit worthiness of the organization, but a plan will generally encompass market share and financial forecasts.

Using internal resources to develop a strategic capital plan will help build consensus through greater understanding of the organization’s future finances. Planning team members will provide input on key drivers of future performance and be prepared to discuss the rationale and reasonableness of assumptions driving the modeling output. It also can provide another level of assurance to the board for approval of funding for subsequent steps in architectural planning and mechanical engineering in the early planning stages knowing that a team effort helped drive recommendations.

Finally, this higher level of planning done by your internal staff can inform a more detailed feasibility study performed by an independent consultant and required by lenders and/or the capital markets to streamline a sometimes onerous process. In the end, knowing “what if” empowers the organization through objective, reasonable financial expectations.

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