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DMC more profitable under Vanguard than as a nonprofit; reasons, amount debated

By Jay Greene

The **Detroit Medical Center** increased profitability during its first two years as a for-profit system owned by **Vanguard Health Systems Inc.** and did so at a faster rate than when it was a nonprofit system, according to a review of Medicare cost reports and interviews with DMC officials.

The DMC disputes the size of the increase in net income. It believes net income increased 16 percent from 2010 to 2012 rather than the 130 percent shown by DMC's Medicare cost reports that all hospitals are required to file annually.

But there's no dispute that through a combination of aggressive cost reductions and revenue enhancement, the eight-hospital DMC system cut operating losses 90 percent — a $120 million turnaround — compared with its last year as a nonprofit in 2010, according to the cost reports provided to Crain's by Louisville, Ky.-based **Cost Report Data Resources**.

"From the date we acquired DMC, we had operating expense efficiencies," said Phil Roe, a former Vanguard CFO who now is senior vice president of finance for **Tenet Healthcare Corp.**, which acquired Nashville, Tenn.-based Vanguard last Oct. 1.

"We saw and treated more patients in 2011 and 2012."

Roe attributed revenue increases to adjusted discharges that increased 4.9 percent in 2011 and an additional 2 percent in 2012. The measure of adjusted discharges portrays the overall impact of inpatient and outpatient volume.

"Some of that we believe was due to

DMC net income

- **2010**: $54.9 million
- **2010** (minus one-time payments): $108.9 million
- **2012**: $126.1 million

Source: Cost Report Data Resources

DMC vital signs

DMC operating losses:

- **2010**: $132.2 million
- **2012**: $12.3 million

DMC revenue:

- **2010**: $1.62 billion
- **2012**: $1.72 billion

Total adjusted discharges:

ED BOTTOMLEY/DETROIT MEDICAL CENTER

Pam Torrance, care management specialist at Children's Hospital of Michigan, shows DMC CEO Joe Mullany (left) and others the key performance metrics on a department's lean management board during a daily round by hospital executives.

Determining profits is a numbers game

So how much did profits improve for the **Detroit Medical Center** after it was purchased by **Vanguard Health Systems Inc.** at the end of 2010?

It depends on what set of numbers you use.

As the chart below shows, Medicare cost reports provided by Louisville, Ky.-based **Cost Report Data Resources** show DMC profits rose more than $70 million from 2010 to 2012.

But Phil Roe, Vanguard CFO at the time, said 2010 net income was artificially low because of two one-time payments: $24 million to underfunded pensions and a $30 million fine the DMC paid to settle fraud allegations.

Roe said the DMC's profits were lower still when judged by generally accepted accounting principles, but he declined to provide numbers.

confidence in the health care community," Roe said. "We were beginning to spend capital dollars on the Detroit campus, and physicians and others saw we were serious about investing in the community."

- **2010**: 124,827
- **2011**: 125,665
- **2012**: 132,762

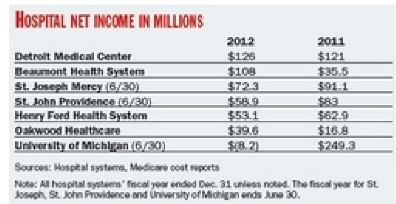
Source: Cost Report Data Resources

Joshua Nemzoff, president of **Nemzoff & Co.**, a New Hope, Pa.-based consulting firm, said most nonprofit hospitals improve profitability during the first two years under investor-owned management.

One of the reasons that nonprofit hospitals join large for-profit systems is to achieve economies of scale, Nemzoff said.

"DMC was able to reduce costs because of Vanguard's purchasing power," he said.

Even so, "the magnitude of the improvement was pretty dramatic, especially since it was done at an inner-city hospital in Detroit," said Nemzoff, an expert in advising nonprofit hospitals in mergers and acquisitions.



HOSPITAL NET INCOME IN MILLIONS

	2012	2011
Detroit Medical Center	$126	$121
Beaumont Health System	$108	$35.5
St. Joseph Mercy (6/30)	$72.3	$91.1
St. John Providence (6/30)	$58.9	$83
Henry Ford Health System	$53.1	$62.9
Oakwood Healthcare	$39.6	$16.8
University of Michigan (6/30)	$(8.2)	$249.3

Sources: Hospital systems, Medicare cost reports

Note: All hospital systems' fiscal year ended Dec. 31 unless noted. The fiscal year for St. Joseph, St. John Providence and University of Michigan ends June 30.

(click to enlarge)

Path to profits

At the time of the sale to Vanguard, the DMC was profitable, generating cumulative net income of about $230 million from 2004 to 2010 under then-CEO Mike Duggan, now Detroit mayor. But that still is less than the $247 million in net income Vanguard generated in just two years of operation after the Dec. 31, 2010, sale, according to DMC executives, outside experts and audited financial statements obtained by Crain's.

"They improved gross revenue with a somewhat better payer mix. They increased outpatient revenues and reduced write-offs," said Tom Schuhmann, senior vice president of finance at Cost Reports Data, who analyzed the DMC's cost reports for Crain's.

"DMC had a significant decrease in operating expenses in 2011 — $34 million or 2 percent," Schuhmann said. "They operated the hospital like a for-profit. They couldn't have had these results" if it were business as usual, he said.

Phil Roe

While Roe disputed the Medicare cost report trends, he said Vanguard was able to help the DMC cut costs dramatically by negotiating more favorable contracts with third-party vendors, managed care payers, and medical and pharmaceutical suppliers.

"We identified operating expense efficiencies, making capital investments and taking care (of patients) in cost-efficient ways," Roe said.

And there may have been other reasons.

Keith Pitts, who was vice chairman of Vanguard and now holds the same position at Tenet, said the DMC reduced costs in a number of ways under Vanguard. But he said Medicare cost report data do not account for DMC expenses picked up by Vanguard's corporate office in 2011.

"There were a huge amount of (expenses) running through the home office" in 2011, Pitts said.

Some of the DMC costs that shifted to Vanguard include interest expenses, pension expenses, legal services, internal audit, some accounting and Medicare compliance, Pitts said.

Said Roe: "We still allocated proportionate amounts of services to DMC, but the total costs went down."

Staff cuts

In 2011 and 2012, Crain's reported several management decisions that also helped to reduce expenses.

For example, the DMC cut costs by severing a long-standing relationship in early 2012 with the **Reynolds Group**, a medical group composed mostly of radiologists at **Wayne State University**, and contracting with **Imaging Advantage LLC**, a Santa Monica, Calif.-based radiology group.

In July 2012, the DMC reduced staff expenses by cutting the number of nurse midwives and eliminating clinics at **Hutzel Women's Hospital**, where at least seven of the nurses treated their own patients. Many of the DMC midwives were recruited to join **Oakwood Healthcare** in Dearborn.

The DMC's former midwife group had full medical staff privileges to see patients in their own offices within the medical center. The remaining midwives at the DMC now have privileges to support only private obstetricians, who reportedly pushed the medical center to make the changes.

Beginning in 2011, the DMC began a review of labor productivity and lean processing at its eight hospitals that cut costs. The reviews led to an unspecified number of layoffs and dozens of other positions left unfilled.

DMC Sinai-Grace Hospital, for example, laid off 20 nonclinical employees, Crain's reported.

"Labor costs were reduced. There were some staffing reductions in nonpatient care areas," Roe said.

However, he said, the the DMC's full-time-equivalent staff increased 2 percent in 2011, to 14,129 from 13,822. In 2012, the DMC cut staff 1 percent, to 13,984. Last year, it cut staff again by 2 percent.

Cost cuts

In its first year as a for-profit hospital under Vanguard ownership, the DMC cut operating expenses 1.9 percent, to $1.719 billion in 2011 from $1.753 billion in 2010. That amount is fairly typical after for-profit chains take over nonprofits, Schuhmann said.

"Operating expenses were reduced mainly by controlling labor costs ... probably eliminating a lot of contract labor and overtime hours," he said.

For example, the percentage of wage and related expenses to total operating expenses at **DMC Detroit Receiving Hospital** dropped to 63.5 percent in 2012 from 70.1 percent in 2010. Other DMC hospitals had similar reductions except for the **DMC Rehabilitation Institute of Michigan**, which increased its percentage of wages to operating expenses to 84 percent from 70 percent.

Total hourly wage rates at Detroit Receiving dropped to $34.41 in 2012 from $36.26 in 2010, and **DMC Harper University Hospital** dropped to $33.20 from $36.70, the federal cost reports said.

However, Roe said the decrease in hourly rates primarily was due to removing employed physicians from the DMC's labor costs.

"We moved all employed physicians into a 501(a) entity under the tax code" starting in 2011, Roe said. (A 501(a) is a nonprofit health entity that hospitals create to manage employed physicians.) Roe added that the reduction in labor costs compared with 2010 made it look like hourly rates were lowered. "We no longer were allowed to include physician-employed activity" in hospital cost reports, he said.

Roe said average hourly wage rates of the remaining employees and nurses increased 7 percent, to $29.27 in December 2012 from $27.33 in January 2011.

Nemzoff said for-profit hospitals typically cut labor expenses when they change ownership.

Average labor costs of for-profit hospitals are much lower, at 38 percent to 42 percent of revenue, than nonprofit hospitals, at 50 percent to 55 percent, he said.

"There are a lot of components of labor," Nemzoff said. "For-profits start to cut overtime, agency usage, benefits; they convert people from full time to part time; and they do a better job at flexing people off." Flexible staffing allows hospitals to send home workers during their shift when patient volumes decline.

Vicki Bryan, an analyst with New York City-based **Gimme Credit**, said Vanguard knew it needed to address high staffing costs within its hospital group.

In 2011, staffing costs at Vanguard's 28 hospitals, including DMC hospitals, were 56 percent of net revenue, at the high end in the for-profit industry.

"These numbers were mostly driven by higher labor costs at the DMC hospitals," Bryan said.

By 2012, Vanguard had reduced companywide labor costs to 46 percent, she said.

"DMC is doing better (financially) than it was — but compared to what?" she said. "DMC is still losing money on patient care operations" — a $12 million loss in 2012.

Financial data for the DMC were unavailable for 2013.

Revenue gains

By year two under Vanguard, the DMC improved on its first-year profit as a for-profit system mostly by generating a 3.9 percent increase in net revenue to $1.723 billion.

At the time, Duggan told Crain's that the DMC was generating higher revenue and profits from surgery, cardiology and children's services.

The DMC "improved gross revenue with a somewhat better payer mix (less Medicaid and more commercial insurance) and increasing outpatient revenues while reducing write-offs (bad debt)," Schuhmann said.

Roe said write-offs declined because the DMC further improved its revenue collection from patients and commercial payers.

Over the past two years, the medical center has continued to reduce costs by continuing to better control supply costs, vendor contracts and economies of scale, said Joe Mullany, the DMC's CEO.

Last March, Mullany announced the layoffs of 300 full-time-equivalent staff or 2 percent of the DMC's workforce. He said the layoffs were prompted by a 2 percent reduction in Medicare payments.

"Our caregiver (nurse-to-patient) ratios have not changed," Mullany said. "Everything we have done as an organization since Vanguard (took over) has been to allocate more resources to the bedside. There is more contact with the patients."

He said the workforce reductions eliminated duplicate and overlapping positions and corporate overhead costs.

Last May, Mullany began daily lean management walks, where administrators walk the floors of DMC hospitals to listen to employees talk about how they would go about reducing costs.

"The benefits are in elimination of waste and inefficiencies, improvement in quality. We are driving out costs at the lowest level," he said.

On the revenue side, Mullany said, the DMC's revenue continues to increase despite a hospital market that is shrinking in total revenue. He cited growing areas that include neurosurgery, cardiology, outpatient services, rehabilitation and reference laboratory services.

"We have improved coding, collecting, all things that help with revenue," he said. "We are improving our mix of patients, working with specialists and focusing on necessary services."

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