Judging new ventures: Study the plan

by Barry P. Chaiken, M.D., Peter F. Rettig, and Paul T. Breslin

THE RISE OF PROSPECTIVE pricing and the decline of cost-based reimbursement have created a new reality in which proposals for new ventures must be judged. No longer can hospitals expand services with the expectation that all expenses will be reimbursed. Today, projects must demonstrate a potential to succeed on their own merits.

An informed decision about a new venture must be based on careful analysis of financial and nonfinancial costs and benefits. The new reality demands well-prepared, rigorous business plans that provide project evaluators, such as governing boards and senior management, with key information.

In presenting that information, a useful business plan treats the project evaluators as if they were investors in the project. Of course hospital trustees and executives do not commit their own money, but their fiduciary responsibilities require them to judge each new proposal as if they did.

Those who evaluate proposals for new hospital ventures should look for the following information in the business plan for the project:

Need for and ability to offer the new product or service. It is always less risky to offer a product or service for which there is an existing need. Very few products create their own demand; those that do are usually driven by huge marketing budgets.

It is also less risky to offer a product or service in which the hospital has some existing capability. A project is more likely to succeed if the proposed service is similar to others in which the hospital already has expertise: The level of uncertainty and the financial risk will be lower.

Quantification of the market. A successful project is usually market driven, not product driven. Proposals for new products or services sometimes grow out of the enthusiasm of a small group of staff. Carefully assembled information from market research will tell whether that enthusiasm is backed by existing and potentially growing demand.

The business plan for the project should analyze the demographics of the market, identify the actual purchasers of the new service, and document the benefits that those purchasers will receive. Also, documentation of interest in the new service, the nature of the competition, and evidence of a unique market position will help in projecting future demand and in setting up a pricing structure.

> An informed decision about a new venture must be based on careful analysis of financial and nonfinancial costs and benefits

Market information should come from both formal and informal research. Informal market research, which includes discussions with medical staff leaders, administrators, patients, and competitors, helps focus the project and direct formal market research. Formal market research follows through with information collected by means of surveys and focus groups using standardized methods. Thorough market research, both formal and informal, increases the credibility of volume and growth projections.

How the business will work. A clear, detailed explanation of the operation of the new service will reduce the likelihood of unforeseen problems in implementation. The business plan for the project should describe location, equipment and staffing needs, hours of operation, and means of communication with other hospital services and staff. Whether the new service is a department, freestanding facility, or separate corporation, its relationship to the hospital will obviously greatly affect its impact on the hospital.

Financial analysis. The credibility of financial models and projections depends on the care put into other sections of the plan, such as market research. Usually, a plan includes a capital budget that projects anticipated start-up expenditures and operating pro formas that project the revenues and expenses over several years.

When evaluating the financial merits of a project, a critical assessment of volume projections is crucial. Overestimation of volume leads to unreliable break-even analysis, erroneous return-on-investment calculations, and investment in projects that do not deserve the assigned level of resource commitment. Underestimation of volume leads to inadequate equipment and staffing and unsatisfied patients and staff. This very important variable is the most difficult to predict and is often assumed.

At a minimum, believable volume projections will be consistent with industry norms or experience in similar hospitals. Preferably, the projections should be supported by sound market research.

Summary of nonfinancial benefits. A new venture's contribution need not always be financial. Nonfinancial considerations, such as the community's needs and the consistency of the new venture with the hospital's mission, may outweigh return on investment and provide a strong argument in the project's favor. In fact, the mission statement should always set purpose and direction when new ventures are evaluated; it is the hospital's raison d'être and must always be heeded.

However, nonfinancial factors need not be considered in a vacuum, devoid of the rigors applied to financial factors. For example, the volume projections necessary for financial analysis of a proposed venture can also be critical to predicting nonfinancial benefits, because they estimate the number of people in the community who stand to benefit from the new service.

(continued on page 23)

Strategic Planning *continued*

Project schedule. A project schedule should show "go/no go" decision points and milestones for implementation of the new venture. A useful schedule presents realistic time frames that take internal and external review and approval processes into account. Also, a cash-flow schedule should show when the initial capital outlays will be spent.

Assuming a plan contains this necessary information, trustees or other project evaluators can make an informed decision about the proposal.

An intelligent decision will be based on the degree to which the project is projected to maximize financial benefits (or minimize losses) while maximizing the hospital's ability to fulfill its mission. Competing projects must be considered together; limited investment resources often force trustees and executives to choose among several. A project that does not optimize *overall* benefits, by comparison with competing projects, may need to be dropped. Whether a project is expected to improve the bottom line or not, the evaluators should know how much the hospital can afford to invest and to lose.

The effort to optimize overall benefits may very well lead to a decision to go ahead with a new venture that will give a poor financial performance while offering countervailing nonfinancial benefits. In any case, however, an informed decision about a project is one based upon a rigorous review of a business plan that clearly defines and measures both financial and nonfinancial costs and benefits. ■

Barry P. Chaiken, M.D., is a consultant, Peter F. Rettig is a founding principal, and Paul T. Breslin is a principal with the Bristol Group, Boston.

Index to Advertisers