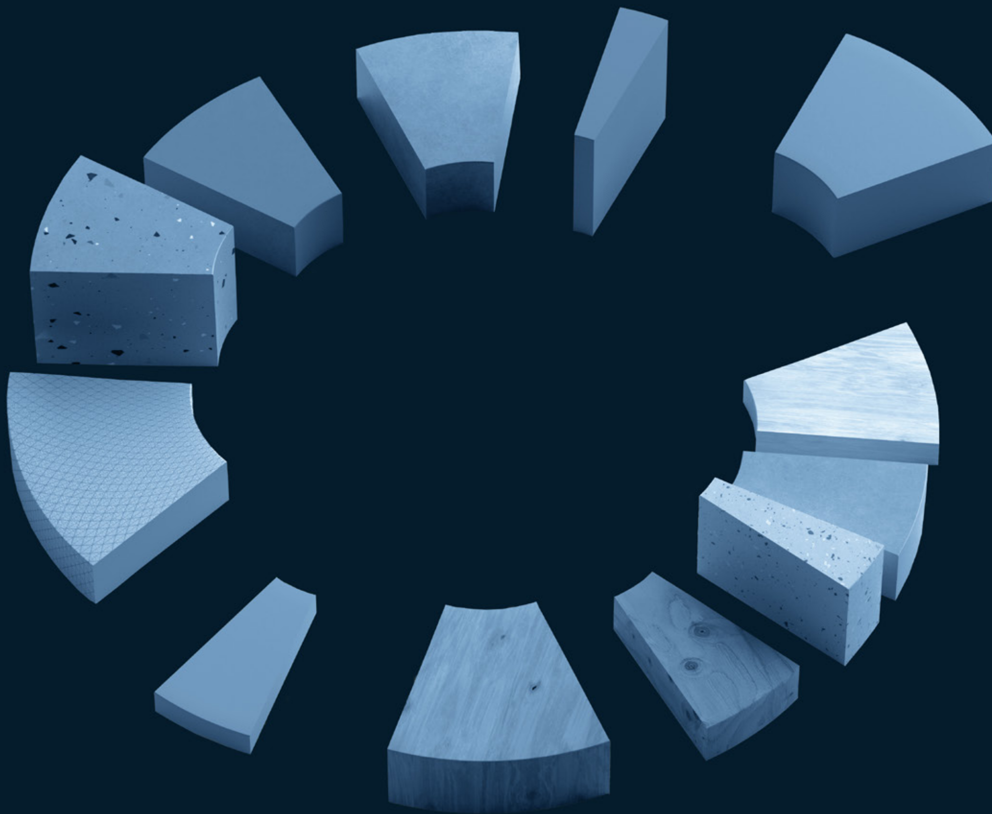
McKinsey & Company

Healthcare Practice

US health systems: Diversify to thrive

US health systems are diversifying their businesses to unlock growth and support core hospital operations, carefully choosing investment areas and structures in line with their objectives.

by Jason Azzoparde, Rupal Malani, Neil Rao, and Shubham Singhal



© Andriy Onufriyenko/Getty Images

November 2022

In a challenging economic environment coming out of the COVID-19 pandemic, US health systems are accelerating diversification strategies to participate in new, high-growth healthcare segments and to support core hospital operations. They are seeking to simultaneously diversify revenue sources outside of core hospital operations and build (or acquire) capabilities that can also benefit the core—for example, by improving patient access, quality of care, experience, and affordability.

We surveyed health system executives to learn more about their diversification strategies (see sidebar "Survey methodology"). More than 70 percent of survey respondents said they intend to invest more in diversification over the next three years. This article explores the reasons health system executives are pursuing diversification strategies, the areas in which they plan to invest, the structures they could use to support their diversification objectives, and considerations for effective business building.

Survey methodology

From March 2022 to July 2022, McKinsey surveyed 76 health system executives who currently lead hospital and health systems across the United States. One-third of respondents (33 percent) serve for-profit health systems, and the remaining two-thirds serve not-for-profit systems. Respondent roles included chief strategy officer (29 percent of respondents), CEO (13 percent), CFO (12 percent), and other C-suite positions (30 percent). All survey responses were based on the experiences of the individual professional.

Diversification could bolster health system performance

At present, hospitals still represent the largest profit pool in the care delivery segment; however, other care segments are growing much more quickly and are projected to capture an increasing share of industry profits (Exhibit 1).[1] Meanwhile, industry trends may present challenges for health systems as the shift to care delivery in ambulatory settings accelerates; labor and supply costs rapidly escalate in an inflationary environment; insurance coverage shifts to government plans; and risk-sharing, value-based care models continue to gain momentum.[2]

As a result of these challenging fundamentals, industry median operating EBITDA margins for not-for-profit health systems have been gradually but steadily declining, from 11.6 percent in 2012 to 8.6 percent in 2020, with no reversal in sight.[3] In fact, Moody's has issued a negative outlook for the not-for-profit healthcare sector for 2022.[4] Non-operating investment income had largely offset declining operating income, helping health systems carry on despite challenging operating conditions. However, as of early 2022, many health systems experienced substantial investment losses, which, when combined with rising costs, exposed the gaps in the systems' financial performance and prompted executives to step up their diversification efforts (Exhibit 2).[5]

Meanwhile, health systems increasingly compete against well-capitalized incumbents from other healthcare segments and other industries—including payers, private equity–backed medical groups, pharmacy benefits managers, technology companies, and other healthcare services firms—that are aggregating care delivery assets to create large healthcare ecosystems.[6] In fact, five of the largest for-profit healthcare payers have already deployed more than $120 billion of capital over

[1] Neha Patel and Shubham Singhal, "The future of US healthcare: What's next for the industry post-COVID-19," McKinsey, July 19, 2022.
[2] Daniel Brown, Addie Fleron, Shubham Singhal, and Drew Ungerman, "The gathering storm: An opportunity to reorder the healthcare industry," McKinsey, September 23, 2022.
[3] U.S. not-for-profit health care system median financial ratios—2012 vs. 2020 (S&P Global Ratings; n = 146).
[4] "Moody's - 2021 outlook for US not-for-profit and public healthcare sector remains negative on constrained revenue, rising costs," Moody's Investor Service, December 11, 2020.
[5] Sample taken of the top ten not-for-profit US health systems.
[6] We define an ecosystem as a set of capabilities and services that integrates value chain participants (customers, suppliers, and platform and service providers) through a common commercial model and through a virtual data backbone, both to create improved and efficient consumer and stakeholder experiences and to solve significant pain points or inefficiencies.

the past five years on diversified assets and will likely continue to invest at an accelerated pace.[7] Notably, they have largely excluded legacy acute care from those investments.[8]

In this environment, health systems executives increasingly perceive diversification as critical to their future performance and growth. The most common reasons that health systems executives cited for

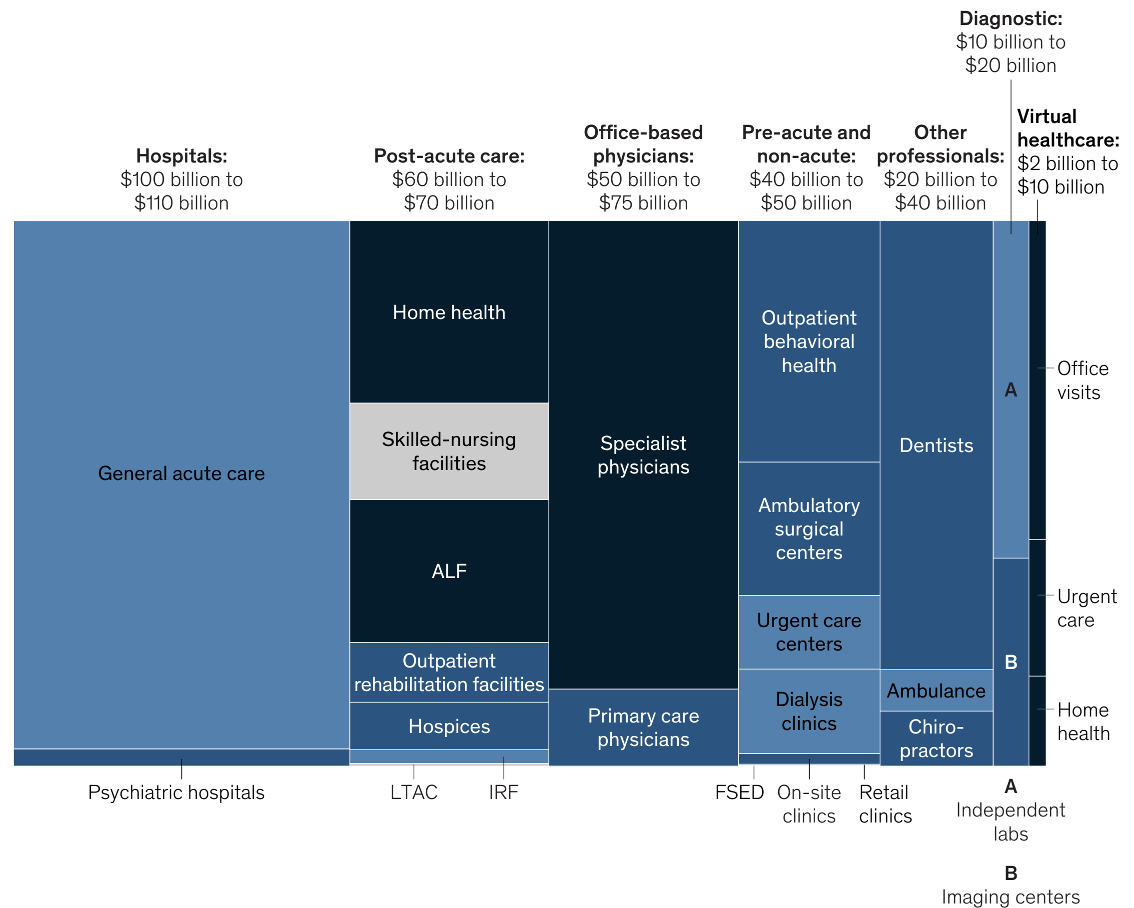
[7] The breakdown of capital by payer is as follows: Optum, more than $50 billion; Cigna, more than $17 billion; CenterWell, more than $12 billion; Aetna CVS, more than $33 billion; and Anthem, more than $12 billion. This information may be inclusive of some health plan roll-ups and is based on publicly available deals information (Tracxn). It includes the Cigna–ESI deal of about $54 billion and the Aetna–CVS deal of about $78 billion.

[8] Zachary Greenberg, Basel Kayyali, Rob Levin, and Shubham Singhal, "The next wave of healthcare innovation: The evolution of ecosystems," McKinsey, June 23, 2020.

Exhibit 1

Segments with the highest projected growth rates are largely outside of acute care.

Distribution of projected healthcare EBITDA across provider segments, 2025, 100% = ~$300 billion to $350 billion

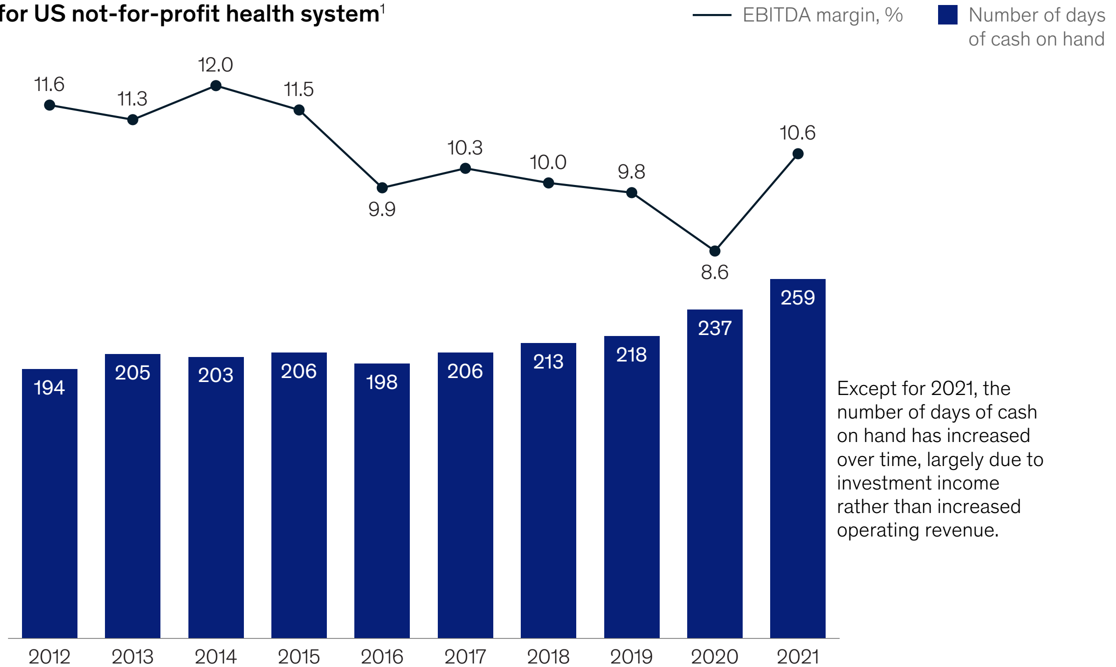


Note: FSED = freestanding emergency department; ALF = assisted-living facilities; Hospice = palliative-care centers; IRF = inpatient rehabilitation facilities; LTAC = long-term acute-care hospitals.
Source: McKinsey Profit Pools analysis

Exhibit 2

Rising operating costs and reliance on investment income leave health systems vulnerable to economic downturns.

Median days' cash on hand and EBITDA margin for US not-for-profit health system[1]



[1]U.S. not-for-profit health care system median financial ratios—2021 (S&P Global Ratings; n = 140+).
Source: S&P Global Ratings

diversification were generating cash flow and creating value and capabilities for their core hospital business (Exhibit 3). For example, a health system could acquire a risk-bearing primary care group, thus creating better alignment with physicians and improving continuity of care for patients while also integrating administrators and supporting technology into other geographies.[9]

Key questions for health systems pursuing diversification strategies

Based on our experience standing up diversified growth entities in healthcare and other industries, several questions and actions can help health systems optimize the value of their diversification efforts.

Answering questions related to the strategy (the "what") and the business infrastructure (the "how") are early decision points that can set up the diversified business for success (Exhibit 4).

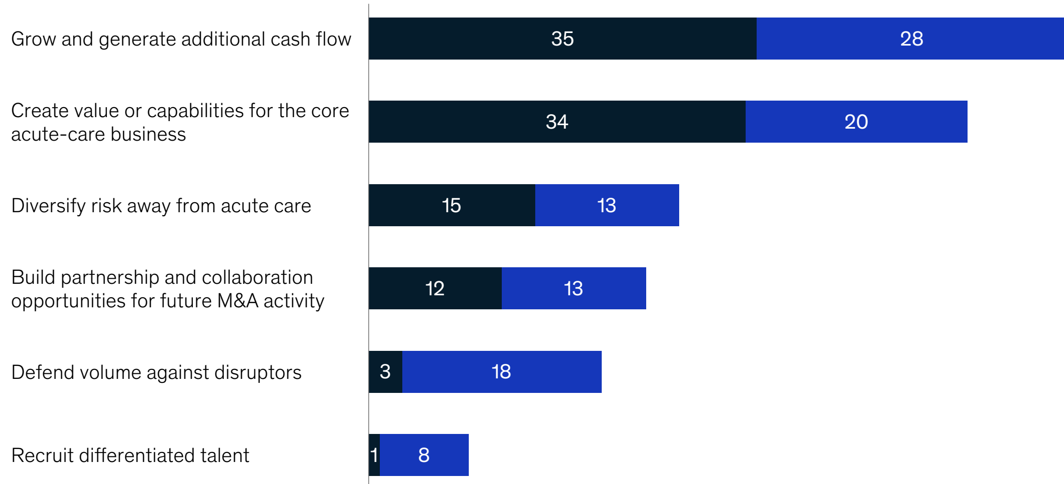
Innovative health systems are investing in line with their growth strategies

Health system investments in diversification typically align with three growth strategies: monetizing existing capabilities, expanding beyond acute care, and building innovation capabilities (Exhibit 5). Health system executives can then consider the specific pathways to pursue to achieve their stated objectives. To monetize their existing capabilities, for example, they could transform a cost center (such as the revenue cycle or supply chain function)

[9] McKinsey Healthcare Provider CXO Survey on Revenue Diversification, July 2022.

Exhibit 3

Most health systems build diversified revenue business units to grow and create value for the core acute-care business.



Source: McKinsey Healthcare Provider CXO Survey on Revenue Diversification (n = 76), July 2022

Exhibit 4

Navigating early decision points can set the business up for success.

Define the strategy (the "what")

Vision and value proposition
What should our organization look like in 5 to 10 years, and how will diversification and business building help us advance in that direction?

Priority investment areas
What approaches will we take to diversify growth, and what priority investment themes will we pursue (strategic or financial value)?

Long-range financial plan
What financial guardrails will we build into our budget and long-range financial plan (eg, expected size, growth, KPIs, or capital allocation)?

Growth plan development
What are the opportunities for growth across themes, including synergies with the core or other system businesses? What funding will be required?

Proactive deal sourcing
Within the vision, priority themes, and guardrails, what are potential acquisitions the health system should consider (with support from bankers)?

Build the business infrastructure (the "how")

Legal structure of new entity
What should the legal structure of the new business look like? Will it be structured as an operating company or holding company?

Governance and operating model
What governance structures and mechanisms will guide the ways of working between the new businesses and core system (eg, service-level agreements)?

Fiduciary structure and capital planning
How much capital will we set aside for business building? How will funding be released, and how will it be buffered from our core budgeting cycle?

Talent strategy and recruitment
What will our strategy be for sourcing and attracting talent? What incentives and career paths will we develop to support rapid testing and learning?

Operational road map
What is our action plan for outlining the communication strategy, development of institutional partnerships, and organizational changes?

Exhibit 5

Larger systems have been building businesses across three core growth themes.

into a profit center, or they could extend internally developed care models to other providers (for instance, hospital-at-home providers).

As they pursue strategies aligned with their diversification objectives, health systems can choose among many different healthcare segments to target for investment. We explored interest in these segments in the diversification survey and overlaid the results with our 2021–25 EBITDA growth projections (Exhibit 6).[10] Indeed, executives are showing a preference for investing in the highest-growth, most profitable segments.

According to the survey, telehealth and remote patient monitoring is the opportunity with the highest area of focus, with 56 percent of respondents ranking it among their top five choices, followed by value-based services (53 percent of respondents), ambulatory surgical centers (36 percent of respondents), and health plans (34 percent of respondents).

When making investment decisions, health system executives can take into account what previous McKinsey research has affirmed: top programmatic acquirers create an M&A blueprint or road map that states where and how M&A will enhance their competitive advantage.[11] In this case, for example, building a hospital shared-services platform (thereby transforming cost centers into profit centers) or offering cohesive ambulatory care services—rather than relying on episodic “big bang” transactions—is far more likely to achieve stronger performance and reduce exposure to risk.[12]

Most health systems plan to use partnerships to support their diversification strategies

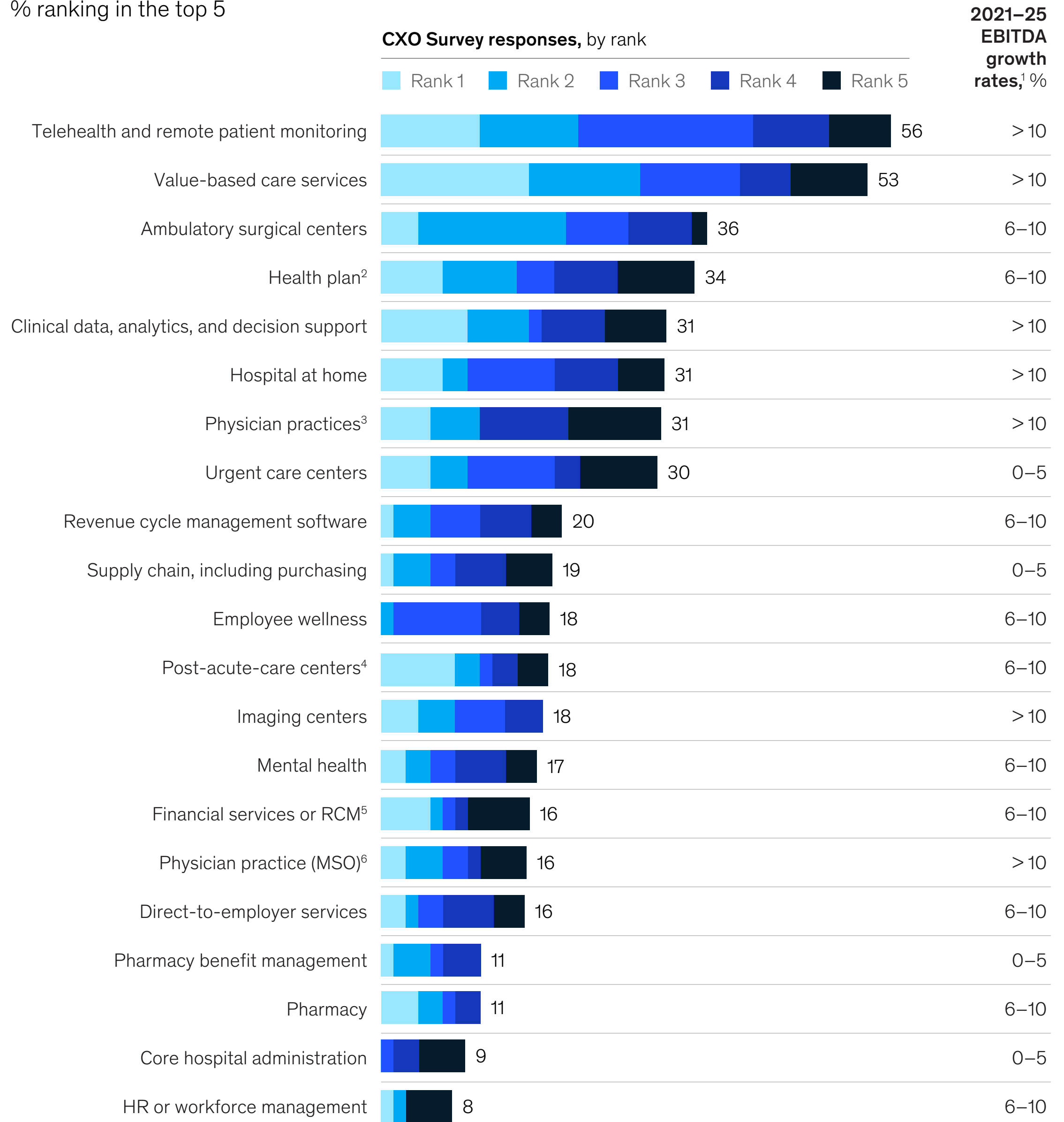
After determining their growth objectives, the specific strategies to pursue them, and the areas in which to invest, health systems can explore the various ways to structure their investments. At a high level, their options include external investment

[10] Based on analysis of McKinsey Profit Pool research (2021–25).
[11] Robert Uhlaner and Liz Wol, “Programmatic M&A: Winning in the new normal,” McKinsey, March 21, 2022.
[12] “How one approach to M&A is more likely to create value than all others,” *McKinsey Quarterly*, October 13, 2021.

Exhibit 6

Telehealth, value-based care services, and ambulatory surgical centers are the most desired investment areas for health systems.

Most desired investment areas,
% ranking in the top 5



[1]Projections based on McKinsey Profit Pools analysis.
[2]Includes government payers projected at 10% or more growth and group payers projected at 0–5% growth.
[3]Includes both primary-care physicians projected at 5–10% growth and specialist physicians projected 10% or more growth.
[4]Includes assisted-living facilities at 10% or more projected growth, outpatient rehabilitation at 5–10% projected growth, skilled-nursing facilities at < 0% projected growth, and hospices at 5–10% projected growth.
[5]Revenue cycle management.
[6]Management services organization. Includes core administrative services at 0–5% projected growth and provider enablement at 10% or more projected growth.
Source: McKinsey Healthcare Provider CXO Survey on Revenue Diversification (n = 76), July 2022; McKinsey Profit Pools analysis

(for instance, making a venture investment or acquisition) or new-business building (for example, via internal innovation, codevelopment, or the monetization of existing capabilities).

Health systems that opt to make direct investments can enter at an early stage—that is, seed capital or Series A to Series C funding—to access more innovative healthcare companies via equity, thus creating strategic value, such as providing access to differentiated talent, technology, and market insights (Exhibit 7). These investments can also create financial value: the sale of equity as valuation increases and there's future cash flow if the start-up eventually becomes profitable. Alternatively, those that aim to generate additional cash flow in the near term or defend share against disruptors typically invest in late-stage companies—Series D or buyout—to accelerate the speed-to-market of the new revenue with more predictable cash flows, thereby creating financial value.

Health systems that seek to create capabilities to boost their core hospital operations may invest in seed capital or Series A funding in healthcare start-ups. With an ownership share, the health system has access to products and can help shape their direction. In return, the health system creates value for the start-up by providing shared services, access to hospitals and patient populations to test and pilot products, and mentoring and coaching through access to the health system's executives.

Corporate venture capital (CVC) funds are gaining favor across industries as a vehicle for housing diversification activity within large enterprises. Among Fortune 100 companies, 75 percent have an active CVC fund, and according to Silicon Valley

Exhibit 7

Health systems generate value from diversification in many ways.

Objectives as they relate to diversified revenue	Seed or Series A	Series B–C	Series D or buyout
Grow and generate additional cash flow			✓
Create value or capabilities for the core acute-care business	✓	✓	
Diversify risk away from acute care	←	✓	→
Build partnership and collaboration opportunities for future M&A activity	←	✓	→
Defend volume against disruptors			✓
Recruit differentiated talent	←	✓	→

Financial value is often generated either through equity transactions or operating income

Source: McKinsey Healthcare Provider CXO Survey on Revenue Diversification (n = 53), April 2022

Bank, the number of CVCs grew nearly 6.5 times between 2010 and 2020.[13] However, CVC fund performance has been mixed, and there is typically no significant relationship between CVC investments and financial outcomes.[14] Although achieving financial success with CVCs is relatively rare and takes longer to manifest than investments in the core hospital business, these funds can be beneficial for start-ups and corporate owners alike, with each enjoying access to fresh insights, collaboration opportunities, and capabilities. Ultimately, the decisions health systems make about how to structure their participation are informed by their specific financial characteristics and capabilities (see sidebar "Questions to guide investment decisions").

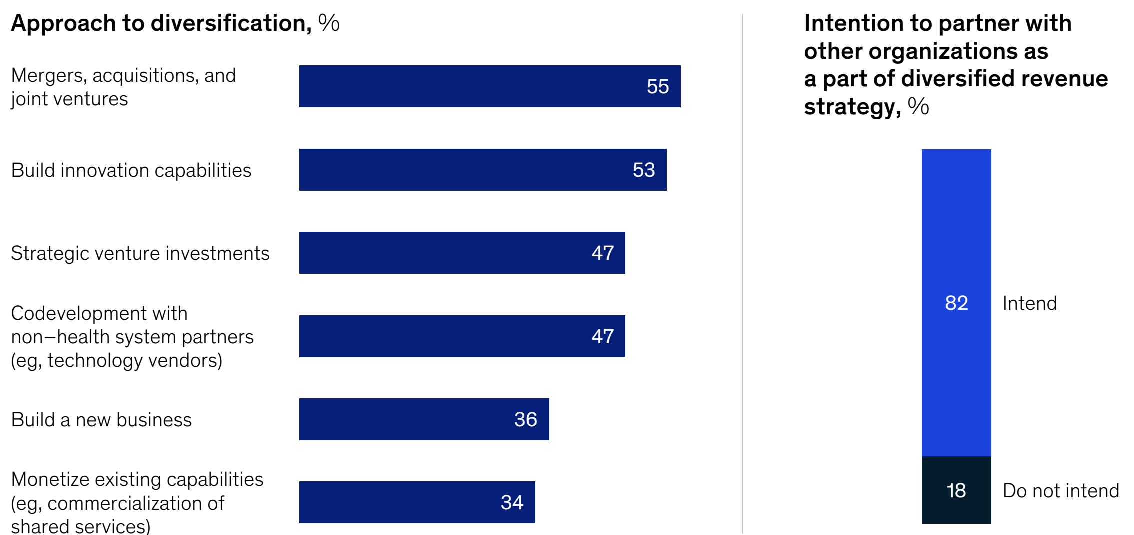
Given the challenges associated with using CVCs as a diversification strategy, most health systems' approaches to diversification have included partnerships or acquisitions, such as M&A, strategic venture investments, or codevelopment with a capital partner. In fact, 82 percent of health system executives who responded to the diversification survey expect to partner with others as they pursue their diversification strategies (Exhibit 8). Furthermore, the shift to care delivery in a variety of new settings favors participants with distinct capabilities (enhanced by greater national scale), which health systems can attain through partnerships and business building—in other words, setting up a new business consortium with multiple health systems to pursue common themes.

However, these health systems have also outlined several guardrails, reflecting the need for a careful approach to form partnerships. Among the surveyed health system executives, 57 percent want to be majority owners, and 19 percent tend not to prioritize partnerships with private equity or venture capital

[13] Bill Alena, "Building a successful corporate venture fund," *Forbes*, September 9, 2022; *The State of CVC*, Silicon Valley Bank and Counterpart Ventures, September 2021.
[14] Patrick Haslanger, Erik E. Lehmann, and Nikolaus Seitz, "The performance effects of corporate venture capital: A meta-analysis," *The Journal of Technology Transfer*, July 13, 2022.

Exhibit 8

Systems are taking different approaches to revenue diversification, but most intend to partner with other organizations.



Source: McKinsey Healthcare Provider CXO Survey on Revenue Diversification (n = 76), July 2022

(VC) firms. Beyond the need to invest within these guardrails, joint ventures (JVs) and partnerships present blind spots—for example, a rush to completion, lack of leadership continuity, declining parent involvement, and insufficient planning to respond to changes in risk profile—that health system executives can work to avoid.[15] A lack of attention to these nuances has led many efforts to fall short of expectations.

Getting started

Ultimately, revenue diversification strategies should create value for the core hospital business and the communities it serves and should support the mission, vision, and overall strategy of the health system. Health systems can consider jump-starting their diversification efforts with a major acquisition or additional investment in internal assets, an approach taken by successful business-building organizations.[16]

When choosing areas in which to invest, those with a clear path to generate value for the core (and ultimately the patients) are more likely to resonate with broader health system stakeholders, including physicians and nurses. Although the new business will likely need some support from the core (for example, shared services), delineating profit and loss between the two entities can assist with performance tracking and provide the new business with enough distance from the core to realize its goals.

Partnerships can accelerate growth and could allow health systems to tap into otherwise hard-to-access resources or expertise. However, health systems could benefit by thoughtfully considering the value they bring to the table in an effort to secure the right partners. Having clear goals and priorities will be important, but, as with any start-up, taking an agile, iterative approach and recognizing when to stay the course versus when to pivot will likely be critical.

Finally, we caution against expecting financial value prematurely; value creation typically takes time and patience. In the meantime, health systems can acknowledge the other benefits to diversification, including building capabilities to better serve patients and expanding knowledge of new markets.

Questions to guide investment decisions

Executives can use a set of questions to guide their investment decision making:

— What is our current and anticipated future capital capacity? In other words, can our financial position support deploying substantial capital for a buyout or only support a more limited minority investment?

— What is our risk profile? Do we have the ability and willingness to invest in higher-risk, early-stage entities?

— What are the cash flow requirements? Does the health system require immediate cash flow, or is it able to wait for investment to materialize in earlier-stage companies? (Investing in later-stage companies provides more defined cash flows.)

Jason Azzoparde is a partner in McKinsey's New York office; **Rupal Malani, MD,** is a senior partner in the Cleveland office; **Neil Rao** is a senior partner in the Seattle office; and **Shubham Singhal,** a senior partner in the Detroit office, is the global leader of the Healthcare and Public Sector Practices.

The authors wish to thank Evan Strother, Ronnie Thompson, Sonia Vora, and Melissa Walek for their contributions to this article.

Designed by Global Editorial Services
Copyright © 2022 McKinsey & Company. All rights reserved.

Find more content like this on the
McKinsey Insights App

Scan • Download • Personalize

[15] John Chao, Eileen Kelly Rinaudo, and Robert Uhlaner, "Avoiding blind spots in your next joint venture," McKinsey, January 1, 2014.
[16] Ari Libarikian and Shubham Singhal, "Leap to the future of healthcare: Reinvent through business building," McKinsey, April 9, 2021.