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The impacts of rising inflation on healthcare supply chain operations

Growing inflation, market uncertainty, and diminishing margins are forcing hospital leadership to make tough decisions about their supply chain costs, price benchmarking, and technology strategy. The Centers for Medicare & Medicaid Services (CMS) predicts that total hospital provider spending will increase by 50 percent from 2022–2030. With growing inflation (currently at 4 percent), healthcare organizations must find ways to achieve savings now more than ever. Balancing these unfavorable financial impacts with the need to invest in their future technology strategy while providing high-quality patient care is a challenging feat. The reality is attaining significant savings today looks vastly different than it did prepandemic. The historical levers that once provided substantial savings are no longer generating the same value. On May 23, Diane Swonk, KPMG chief economist, tweeted regarding an inflation insights survey stating that inflation expectations in a year versus five years from now have fallen, but remain higher for longer than expected. If inflation levels out, healthcare organizations will experience some reprieve.

I What is the problem?

In order to survive the current state, healthcare organizations must find innovative ways to control costs. Close to 30 percent of rural hospitals across the country are at risk for shutting their doors this year due to inflationary challenges. Along with inflationary challenges, hospitals are experiencing a shift from higher-margin elective procedures to lower-margin specialty care. A closer examination of hospital margins indicates supply expenses as the second highest cost to hospital operations. Specialty care, such as respiratory and intensive care, typically have higher supply expenses, currently estimating an increase of 31.5 percent from prepandemic costs. With inflation expectations forecasted to remain higher for longer than expected, there is no return to prepandemic levels in sight. Katelyn Storton, Ann & Robert H. Lurie Children's Hospital of Chicago, stated, "From our perspective at Lurie, the combination of supply shortages and inflationary pressures have resulted in limited ability to negotiate with suppliers and manufacturers. As an example, we have taken increases on certain categories with our primary distributor twice in the last year. To offset price increases, we have been working to move categories to our primary distributor's private-label brand. Ensuring a steady stream of supply is taking precedence to cost savings strategies. As a result, we are working with our Global Purchasing Group (GPO)/Pediatric Alliance to build in failure to supply clauses to keep our vendor partners accountable. These types of clauses and expectations from the providers may continue to intensify the inflationary pressures."

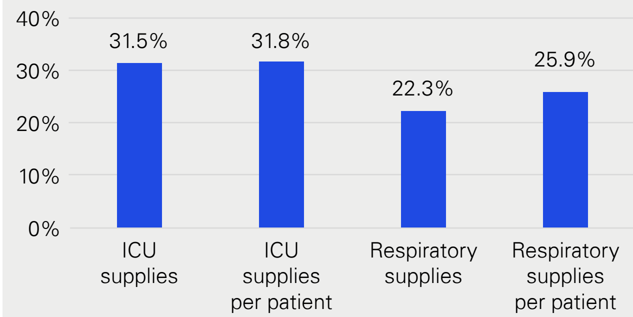
II Why is there a problem?

i. Supply chain operating model shift

Medical supply expenses are the number one cause of increased spending. Since the pandemic, medical supplies have often been backordered or unavailable, forcing organizations to purchase supplies outside of their negotiated pricing agreements. The supply disruptions and off-contract supply expenses have compounded increases in supply costs to healthcare organizations. Along with off-contract supply purchases, hospitals that have negotiated supply agreements between 2022 and 2023, during the current high inflation era, are locked into pricing for two to three years (the typical length of supply agreements). If the base costs return to prepandemic levels, hospitals run the risk of being locked into higher rates until they can renegotiate. These cost increases are rooted in fundamental economics, with demand surpassing supply availability. Manufacturers have been dealing with skyrocketing raw material, freight, and labor costs over the last few years, contributing to the limited room for healthcare organizations to negotiate on pricing. Pharmaceutical supplies, often considered inflation-proof, are not immune to market conditions and could see an approximate 3 percent increase in 2023.

Due to the multitude of supply disruptions, several healthcare organizations are recognizing the benefit of collaborating with a distributor. Distributors can reduce the risks of stockouts through the depth and scope of their inventory. Their ability to take on the carrying costs of holding inventory allows healthcare organizations to be more agile, efficient, and reduce overall costs. Given the current environment, the market continues to consolidate for distributors reducing the number of available partners while increasing their buying power and expanding capabilities to support healthcare providers. As more organizations form alliances, however, supply chain procurement teams have less leverage in negotiating supply pricing. Several organizations are forced to purchase the distributor private-branded products in order to achieve the savings. Fostering a strong partnership with a primary distributor is more of a priority than it has been in the past. Swonk cautions corporate directors that volatility on the horizon will require "more cooperation rather than less" between businesses as the economy transitions to tackle inflation, slowing growth, and higher interest rates.

Increase in medical supply expenses from 2019 to 2021

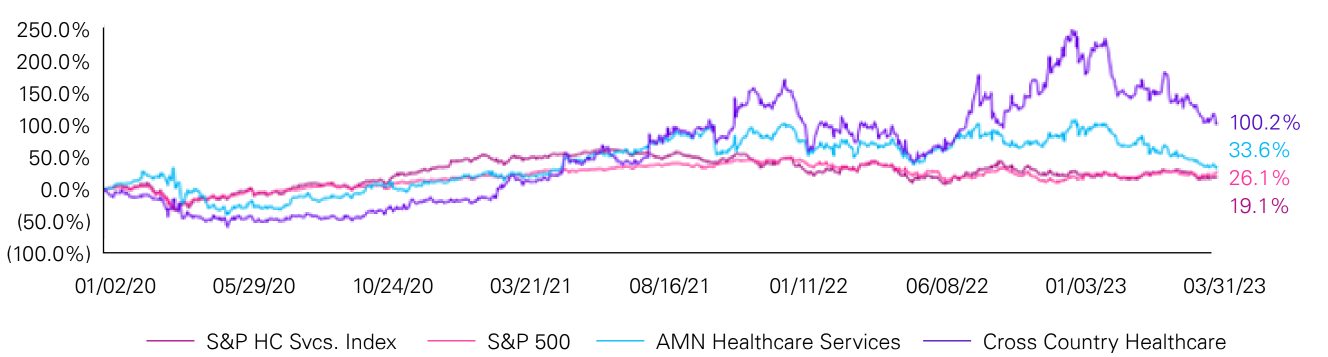


Source: Syntellis Performance Solutions

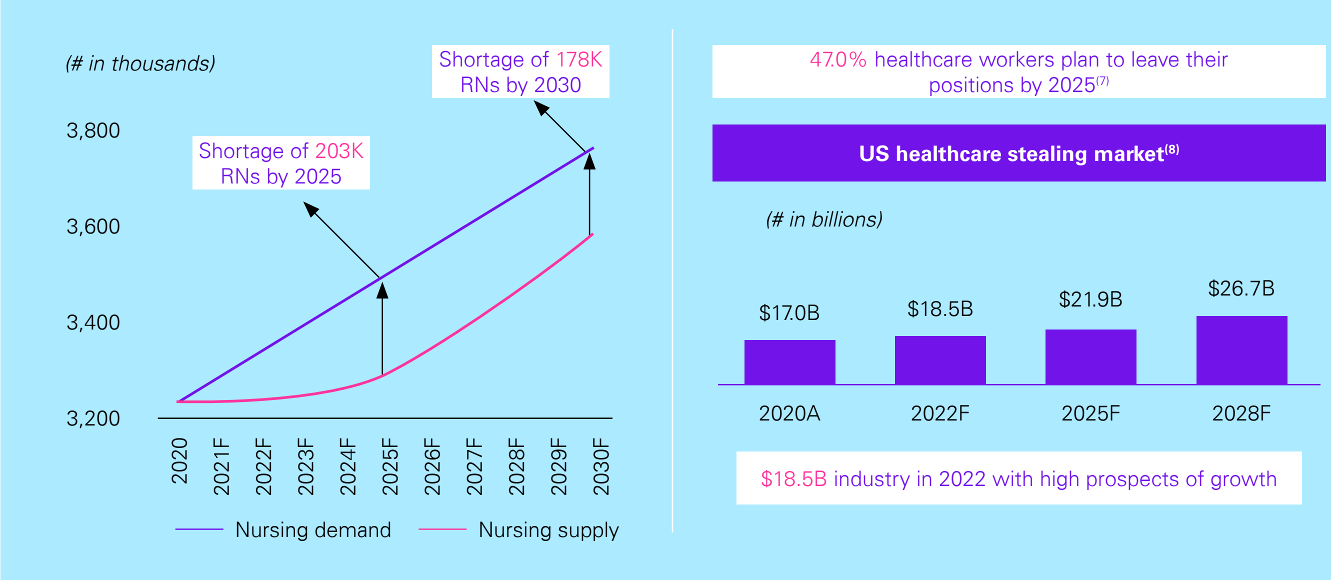
ii. Labor and expense margin

With the onset of the pandemic, the healthcare industry faced the added challenge of frontline worker burnout. Similar to supply disruption leading to increased costs, worker burnout has resulted in increased wages. Additional contributing factors eroding the profitability of healthcare organizations are the aging US population, increased employee healthcare spend, and staffing shortages leading to overtime wage rates or higher-cost temporary staffing. With inflation increasing, hospitals are finding it difficult to keep healthcare workers staffed, engaged, and motivated without extending wage adjustments. At a time when many healthcare organizations are looking for financial relief, they have been forced to adjust frontline staff pay rates while eliminating salaried pay raises and making hard decisions with respect to headcount. In 2022, healthcare workers were at a 4.5 percent income deficit compared to national income levels. Since the pandemic, contracted temporary labor expenses have risen 250 percent. Several large integrated delivery networks (IDNs) spanning across multiple locations have developed internal travel nurse programs to decrease costs and reduce turnover. Retaining nursing staff has become the single most pressing workforce issue for 90 percent of hospital CEOs and CNOs.

Comparative performance: Broader market versus healthcare staffing public companies[(1)*]



Nursing shortage protection[6]*



iii. Delivering high care with minimal technology

While healthcare systems ride the wave of inflation, they are faced with patients scaling back on elective procedures. This has led to increased costs and declining revenue further eroding profit margins for healthcare providers. Between March and September 2020, 15 percent of the population with private insurance deferred care. During this same time, 79 percent of the insured population said they were open to discussing their health issues via a telehealth visit as opposed to in person. While telehealth allows an influx of patients and an alternative way to access care, healthcare providers were met with an immediate need to fast-track their investment in technology infrastructure. This is yet another significant expense to providers impacting overall profitability.

In addition to technology investments to support the growing telemedicine demand, hospitals are struggling with antiquated enterprise resource planning (ERP) systems supporting end-to-end back-office operations. Investing in modernized cloud-based ERP solutions has become necessary. Many organizations do not have the bandwidth or expertise to select the appropriate ERP system and design the system to fit the needs of healthcare providers in the current time. ERP selection criteria must include the visibility to supply spend and expense reporting as well as demand planning. Using ERPs to prioritize data transparency and enable data analytics can be a powerful tool for cost reduction strategies. Rightsizing inventory levels in healthcare organizations to periodic automatic replenishment can result in reduced carrying costs and supply levels that meet clinical demand. An optimized point-of-use inventory management system can result in operational efficiencies such as reduced labor hours to manage supplies, reduced carrying costs, reduced product expiry, and in some cases, increased charge capture. Mature organizations can use advanced reporting to benchmark supply costs across procedures. Investing in smart technology is crucial for healthcare organizations to plan and execute their cost reduction methodology.

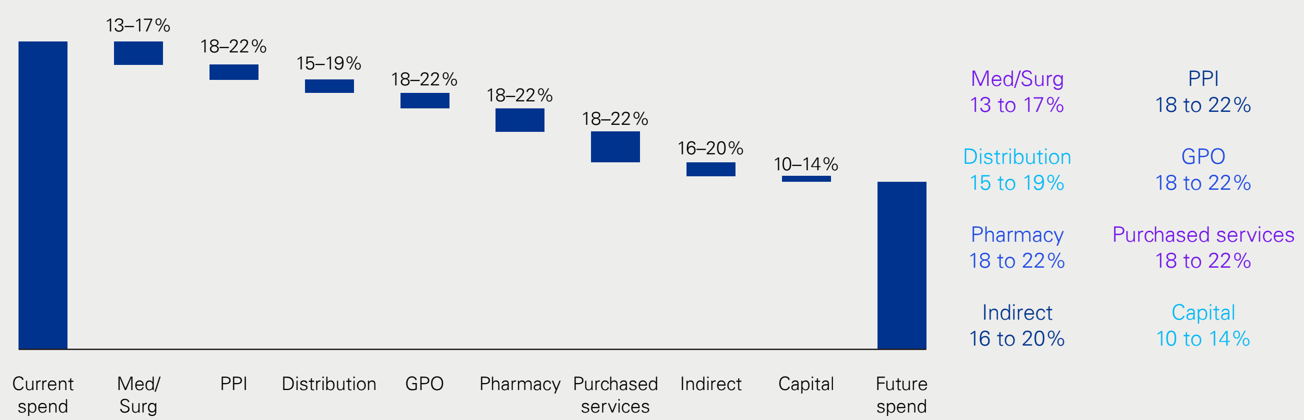
III How can KPMG help to resolve the problem?

The current cost pressures are challenging organizations to go beyond price negotiations pricing and forcing organizations for more sophisticated cost reduction tactics. Advanced category management and value analysis strategies such as supply standardization, vendor consolidation, and key vendor partnerships can lead to more successful cost management. According to industry research, overall global supply chain stabilization may take years and is likely to result in a restructured healthcare operating model. As healthcare organizations are feeling the impacts of inflation and rising costs of operating their business, there are several levers to pull when trying to reduce cost to save money.

Our firm's experienced Supply Chain team can identify areas of improvement and assist you with strategizing, planning, and implementing the following savings initiatives:

	Pain point	KPMG approach
Data-driven pricing strategies	Struggling with multiple vendors for similar products or services	Review current contracts to make recommendations for sole source or vendor consolidation
Price benchmarking	Skewed historical data from the pandemic supply shortages	Pinpoint and prioritize areas of opportunity by leveraging multiple clients' data to normalize pricing
Distribution selection	Increased supply expense purchasing from vendors instead of a distributor in bulk	Select a distributor to lower overhead costs for supplies and make supply chain operations more efficient
Reduction of waste	No clear procedure for rotating supplies or reviewing usage of supplies	Define a method for storing supplies to minimize waste and expiration
Product consolidation	Lack of a value analysis committee to determine what supplies need to be bought from what vendor	Outline a committee to drive initiatives for cost reduction and less stock of the same item
ERP system selection	Limited to no visibility of supply expense and reporting across the organization	All workstreams on one platform can reduce cost and create more visibility for reporting; grow spend to catalog items and require approvals for high-spend supplies
Point of use	Nonexistent perpetual inventory system leads to increase expiring supplies and lack of visibility to supply on hand values	Implementing a point of use tool is beneficial for reflecting par levels and predicting demand

Savings opportunities by category



The KPMG Healthcare Supply Chain Advisory practice has extensive years of experience guiding clients to average savings of 5–15 percent in supplies, pharmaceuticals, capital, and purchased services.

KPMG is here to offer multiple options of cost savings levers for your organization to pull. From helping design the next-generation operating model to deploying supporting technology or refreshing the strategy for products and contracts, we can work with you to make a customized deliverable that fits your organization best. With experienced staff, we can offer multiple solutions to pain points you are experiencing through this period of inflation.

Source: Ann & Robert H. Lurie Children's Hospital of Chicago, Chicago IL, Katelyn Storton (April 11, 2023).
Source: Becker's Hospital Review online article, Leadership & Management, (February 13, 2023)
Source: KPMG Corporate Finance online article, US Healthcare Staffing Market, Q1 2023

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