



# Hospitals and Healthcare Systems: The Rating Approach

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**Fitch Ratings**

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## Presentation Outline

- > Introduction to Fitch Ratings
- > Rating Agencies and Overview of the Ratings Process
- > Criteria for Hospital Credit Analysis
  - Financial Profile
  - Operating Profile
  - Operational Effectiveness
  - Aurora Health Care (WI) Case Study
- > Sector Drivers



## Fitch Ratings Public Finance Health Care Group

- > 9 public finance health care analysts
  - Health care offices: New York (4); Chicago (3); San Francisco (2)
- > 300+ hospital ratings; average hospital rating 'A-'
- > Fitch revised its Outlook on the sector to 'Stable' from 'Negative' in January
  - Signifies that Fitch expects the credit worthiness within the Not-for-Profit Health Care sector to be stable over the next 12 months. We noted that “Although the economic downturn elevated uncompensated care levels and reduced patient volumes, Fitch-rated borrowers generally maintained their operating margins and operating cash flow through meticulous labor management, supply expense control, and ongoing operating efficiency initiatives”
  - Acute care rating actions in 2010:
    - 20 upgrades, 25 downgrades, 182 affirmations



## Fitch Rating Process

- > Bond ratings are an opinion on the likelihood of timely payment of principal and interest.
  - The rating scale runs from ‘AAA’ to ‘D’
- > Rating Steps
  - Gather financial and operational information
  - Meet with management /make a site visit
  - Information put into a credit committee package and presented to a committee
  - Committee decision a consensus
  - A rating action commentary released by the end of the next business day



## Aurora Health Care, Inc. (WI)

- > Twelve hospital system in located throughout eastern Wisconsin
  - 13 hospitals, 1,852 staffed beds, +150 physician clinics, 92,000 discharges in 2009
  - 2009 Stats:
    - > \$3.6 billion in net patient revenues
    - > 3.9% operation margin (\$157.1million)
    - > 2.6x Coverage of Pro Forma Maximum Annual Debt Service
    - > 92 days of cash on hand
- > Fitch assigned an 'A' Rating to the series 2010 bonds and affirmed the 'A' rating on the outstanding bonds. Outlook is Stable



## New Issues

- > Use of Proceeds: Refinancing, capital projects
- > Maximum Annual Debt Service, Amortization
- > Structure
  - Type of Debt, Term, Obligor, Security, Business and Financial Covenants
  - Variable Rate – Term out provisions
  - Swaps
- > Disclosure Disclosure Disclosure
  
- > **Aurora Health Care**
  - \$377.1M Fixed, \$104.2M VRDBs (LOC provided by Bank of Montreal)
  - Refinance outstanding debt, repay for prior expenditures, capital projects
  - Term out on VRDBs – 1 year grace, 3 years, 8.5% interest rate



## Financial Profile: Quantitative Review

- > The financial review is the starting point in the credit review process.
- > Fitch will generally request the following:
  - A minimum of 3 years of audited financial statements
  - The most recent interim financial results compared to prior year results
  - Current and next year budget
  - Auditor calculations on financial covenants



## Financial Profile:

- > From the financial statements, Fitch will measure, review and compare historical
  - Liquidity
  - Profitability
  - Debt Burden
- > What are the trends?
- > How do they compare to other hospital borrowers rated by Fitch?





## Financial Profile

- > Liquidity:
  - Key Ratios: Days Cash on Hand, Days in Accounts Receivable, Days in Current Liabilities, Cushion Ratio (x), Cash to Debt (%)
- > Investment Allocation
  - Level of financial cushion, board policy, alternative investments
  - Cash and liquid investments relative to remarketed and/or puttable debt



## Financial Profile

- > Profitability
  - After the fall 2008, greater emphasis on operating profitability
  - Key Ratios: Operating Margin, Operating EBITDA/ operating cash flow margin, Personnel costs as % of total operating revenue, Bad debt expense as % of total operating revenue
  - Non-patient sources of revenue: tax support, uncompensated care reimbursement (DSH/ UPL)
- > Debt Burden
  - A hospital's size, profitability, and liquidity relative to its debt
  - Capacity for future debt relative to capital need
  - Key Ratios: MADS Coverage (x), MADS as % of Revenues, Debt to Capitalization (x), Debt to EBITDA (%), Average Age of Plant, Capital Spending as % of Depreciation Expense



# Aurora Health Care (WI)

**Agent: Aurora Health Care, Inc. (WI)**

**Model: HOSP**

**Scope: Standard**

	31-Dec-2007 12 Mos Audited	31-Dec-2008 12 Mos Audited	31-Dec-2009 12 Mos Audited		A Medians
<b>Liquidity Ratios</b>					
Days Cash on Hand	81.5	75.2	92.1	-	<b>183.8</b>
Days in Accounts Receivable	27.3	27.7	25.0	+	<b>44.5</b>
Days in Current Liabilities	74.8	81.8	78.3	-	<b>62.7</b>
Cushion Ratio (x)	4.2	4.3	5.9	-	<b>14.4</b>
Cash to Debt (%)	52.3	47.3	60.2	-	<b>105.5</b>
<b>Profitability and Operational Ratios</b>					
Operating Margin (%)	2.9	2.7	3.9	+	<b>3.0</b>
Op EBITDA Margin (%)	10.2	9.1	9.9	-	<b>10.0</b>
Excess Margin (%)	3.0	2.2	3.8	+	<b>3.5</b>
EBITDA Margin (%)	10.4	8.6	9.9	-	<b>10.0</b>
Cash Flow Margin (%)	6.5	7.0	10.1	+	<b>9.4</b>
Supply Costs as a % of Net Patient Revenues	26.3	24.2	21.5		
Personnel Cost as Pct of Revenues (%)	52.5	54.1	53.3	-	<b>50.4</b>
Bad Debt Expense as Pct of Revenues (%)	3.3	4.0	4.0	+	<b>5.4</b>
<b>Capital-Related Ratios</b>					
MADS Coverage - EBITDA (x)	2.2	2.0	2.6	+	<b>3.3</b>
AADS Coverage - EBITDA (x)	2.5	2.4	3.1		
MADS Coverage - Oper EBITDA (x)	2.2	2.2	2.7	+	<b>3.3</b>
MADS Coverage - CFFOBI (x)	1.9	2.0	3.1	+	<b>3.6</b>
AADS as Pct of Revenue (%)	4.1	3.6	3.2	+	<b>3.0</b>
Debt to EBITDA (x)	3.7	4.5	3.7	+	<b>3.8</b>
Debt to Capitalization (%)	62.7	74.5	69.5	-	<b>42.1</b>
Average Age of Plant (Years)	9.1	9.7	10.0	+	<b>10.0</b>
Capital Expenditures as Pct of Depreciation Expense (%)	129.3	219.0	111.5	-	<b>122.4</b>
Capital Expenditures as Pct of Total Revenue (%)	6.5	10.6	5.0	-	<b>6.8</b>



## Operating Profile: Qualitative Review

- > Fitch will assess the operational environment that effects a particular health care provider. Among others things Fitch will assess:
  - Organizational Composition
  - Business Strategy
  - Service Area Characteristics
  - Facilities



## Operating Profile: Organization

### > Hospital

- Tertiary/Major Teaching Facility, Acute-Care/Community Hospital, Rural/Sole Community Provider/Critical Access
- Bed Complement: Private rooms

### > Other “System” Components

- Insurance Plan (HMO), Physician Group Practices (Employed Physicians), Ambulatory Surgery Centers, Urgent Care Centers, Home Health Agencies, Senior Living Communities, Captive Insurance, Durable Medical Equipment, Real Estate (MOBs)

### > Board of Directors

- Mission/Strategic Focus, Composition, Review Practices, Financial Insight and Oversight, Board Development, Sarbanes Oxley/Accountability

### > Executive Management

- Backgrounds, Strategic Plan, Initiatives and Goals, Management Structure, Management Practices, Succession Planning



## Operating Profile

- > **Service Area**
- > Patient Origin/Market Share
  - Primary Service Area/Secondary Service Area
- > Demographic and Socioeconomic Factors
  - Population, Unemployment, Top Employers, Median Household Income, County, City, and State Ratings
- > Competition/Market Share
  - Types of Competitors: Hospitals, Specialty Hospitals, Ambulatory Centers/Clinics/Imaging, Entrepreneurial Physicians
  - Market Share Analysis: Inpatient, outpatient, service line, primary/secondary market



## Operating Profile

### > Facilities

- Plant characteristics: age and condition of facilities and distribution within service area
- Historical spending on capital
- New projects: context within overall strategy and master facilities plan, effect on future revenues/expenses, market position, size of project and management's experience with capital projects



## Aurora Health Care (WI) – Case Study

- > Organization: (PCF)
  - Excellent coverage geographic coverage / diversity
  - Highly integrated delivery system with over 1,200 employed physicians
  - Outstanding quality/ patient safety and clinical IT implementation
- > Board and management: (PCF)
  - Good mix of physicians and community leaders, appropriately sized, excellent professional diversity, have demonstrated willingness to discontinue poorly performing operations
  - Management has been very stable and consistent- 2 CEOs in 15 years
- > Service Area: (NCF)
  - Milwaukee metro service area is highly competitive
  - Demographic profile is consistent with national averages





## Aurora Health Care (WI)

- > Market Share/Competition: (PCF)
  - Growth in leading market share position from 25.0% in 1999 to 29.8% in 2009
  - Next closet competitor at 17.4%
  
- > Facilities – (PCF)
  - All hospital sites in good shape
  - Two new hospitals opened in 2010
  - With the opening of the two hospitals in 2010, the system has completed the “build out” of its integrated delivery health network from Green Bay to Illinois border.
    - > Future capital needs should be manageable



## Operational Effectiveness

- > Fitch will review and assess the effectiveness of a particular health care provider which should be reflected in :
  - Utilization
  - Payor Mix
  - Medical/Nursing Staff
  - Quality and Patient Safety/Information Technology
  - Financial Reporting
  - Regulatory Environment



## Operational Effectiveness

### > Utilization

- Discharges/Admissions: By Clinical Service Line, Adjusted admissions, observation days
- Other: Newborns, Outpatient Visits, Emergency Room Visits, Surgical Volumes
- Average length of stay
- Medicare CMI/Overall CMI

### > Payor Mix

- Medicare/ Medicaid/ Comm/ Managed Care/ Self Pay
- Charity Care/Bad Debt/Upper Payment Limit/Disproportionate Share
- Reimbursement Type
- Current Status of Managed Care/Commercial Insurance Contracts



## Operational Effectiveness

### > Medical Staff

- Number of Active Staff, Avg. Age, Percent Board Certified, Open/Closed Model
- Physician Alignment- Employed Physicians/ Aligned Physicians/ Joint Ventures
- Recruitment and Needs Assessment

### > Nurses

- Vacancy Rate, Turnover Rate, Average Age, Agency/Traveling Nurses Use, Union Representation, Staffing Mix (RNs, LPNs, NP, Aides), Magnet Status

### > Quality and Patient Safety

- Publicly reported quality/safety scores, management initiatives, dashboards, awards/honors
- Reimbursement tied to outcomes

### > Information Technology

- Clinical information systems that focus on improving patient outcomes, increasing operational effectiveness, and responding favorable to payment incentives



## Operational Effectiveness

- > Financial Reporting
  - Frequency, timeliness, and thoroughness (balance sheet, income statement, cash flow, operating statistics, MD&A) for both audited and interim periods
  - Level of commitment to disclose on Municipal Securities Rulemaking Board's EMMA system.
  
- > Regulatory Environment
  - State and Federal budgets, initiatives, and political environment
  - Certificate of Need State



## Aurora Health Care (WI)

- > Utilization – (PCF)
  - Strong growth in OP volumes recently reflecting growing physician base
- > Payor Mix – (PCF)
  - Elevated exposure to government payors
  - Long term managed care contracts with major managed care providers reduce operating risk
- > Medical Staff/Nursing Staff (PCF)
  - Over +1,400 employed physicians which account for over 80% of total system revenues
  - Need to maintain
  - Nursing stats all good. Five hospitals have achieved Magnet Status
- > Quality and Safety/Information Technology – (PCF)
  - AHC named one of 100 “Most Wired” health care providers for 7 consecutive years
  - Clinical IT helping to drive clinical standardization and improved outcomes



## Aurora Health Care (WI)

- > Regulatory Environment (PCF)
  - Wisconsin is CON state- limitation on unfettered competition
  - Medicaid provider tax recently implemented
- > Financial Reporting – (NCF)
  - Financial disclosure is adequate



## **Sector Drivers or Where Health Reform is Taking Us**

- > Quality, Safety, Value
- > Physician Alignment and Care Coordination
- > Information Technology
- > Transparency
- > Market Position/ Scale
- > Accountable Care Organization





# Qs