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 ($157.1 million)
    > 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 remarkeeted 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

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

- Fitch will assess the operational environment that affects 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