

# Analyzing Healthcare Systems and Hospitals

What's on the Horizon ?

*A Rating Agency Perspective*

## **HFMA Southern California Chapter Roundtable**

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## Agenda

- **A.M. Best Company**
  - Company Overview
  - Value Proposition
  - Rating Evaluation
    - What is a Rating?
    - How are Ratings Determined?
    - Key Elements
- **Interactive Credit Ratings**
  - Our Ratings
  - Rating Process
  - Holding Company & Operating Company Analysis
- **State of the Healthcare & Hospital Industry**
  - Trends and Outlook

A.M. BEST COMPANY

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**A.M. Best Company**

## Company Overview

- **Established in 1899**
- **Leading Worldwide**
  - Rating Agency
  - Data Provider
  - Publishing Company
- **Portfolio**
  - Property Insurers in 1906
  - Life & Health Insurers in 1928
  - Health Maintenance Organizations in 1995
  - Hospitals & Health Care Systems publicly in 2007
  - Banks in 2007

## Company Overview

- **Full Service Rating Capabilities**
  - Financial Strength (FSR)
  - Issuer Credit Rating (ICR)
  - Debt
  - Insurance Linked Securities (Commercial paper)
  - Other insurance-related transactions
- **Global Reach**
  - USA
  - London
  - Hong Kong

## Value Proposition

### Hospital & Health Care System Industry

- **Independent Third Party Oversight**
  - Hospital Boards and Senior Management
  - Consultants
- **Validate Financial Strength & Credibility**
  - Banks, Private Grantors, Vendors, Doctors
  - Colleges & Universities that partner with hospitals
- **Satisfy Regulatory/Bonding Requirements**
  - State/Federal Government
  - Medicaid and Medicare
- **Satisfy Health Insurance Company Requirements for Making Referral Decisions**
- **Provide Benchmarking Standards**

## The Rating

What is an A.M. Best Rating?

- An A.M. Best rating is simply a predicted default rate, an opinion of a hospital or system's overall creditworthiness.
- An Issuer Credit Rating (ICR) is assigned to a rated health care system as well as hospital and insurance subsidiaries
- A Financial Strength Rating (FSR) is assigned to insurance subsidiaries

## The Rating

How is the rating determined?

- Quantitative measures and Qualitative information
- The rating process is interactive
- Ratings are customized

# The Rating

## Key Elements

Balance Sheet  
Strength

Operating  
Performance

Business  
Profile

Best's Rating

# Interactive Credit Rating: Ratings

## A.M. Best Ratings

- Financial Strength Ratings (A++ – F)
  - Insurance Companies
- Issuer Credit Ratings (aaa – d/rs)
  - Insurance Companies
  - Insurance Holding Companies
  - Hospitals
  - Healthcare Systems
  - Banks
  - Bank Holding Companies
- Debt Ratings (aaa – d)
  - Long-term and short-term corporate debt and debt-like securities, as well as insurance-linked structured transactions

# FSR & ICR Equivalents

		FSR	ICR			FSR	ICR		
<b>Secure</b>		<b>A++</b>	<b>aaa</b> <b>aa+</b>	<b>Investment Grade</b>		<b>B</b>	<b>bb+</b> <b>bb</b>	<b>Non-Investment Grade</b>	
		A+	aa aa-			B-	bb-		
		<b>A</b>	<b>a+</b> <b>a</b>			<b>C++</b>	<b>b+</b> <b>b</b>		
		A-	a-			C+	b-		
		<b>B++</b>	<b>bbb+</b> <b>bbb</b>			<b>C</b>	<b>ccc+</b> <b>ccc</b>		
		B+	bbb-			C-	ccc- cc		

# Interactive Credit Rating: Rating Process

# The Rating Process



## The Analyst's Role:

### Before Company Meeting

- AMB point of contact
- Study of public data
- Review of internal data
- Initial assessment of strengths and weaknesses
- Set up annual review meeting
- Agenda and guidance
- Meeting package in advance

### At The Meeting

- Assimilate and clarify info
- Discussion and Q&A
- Wrap up
- Additional information requests
- Pressure points
- Advanced notice of possible rating action, outlook change, or affirmation
- Initial timeline for rating conclusion
- Feedback on presentation materials

## The Analyst's Role:

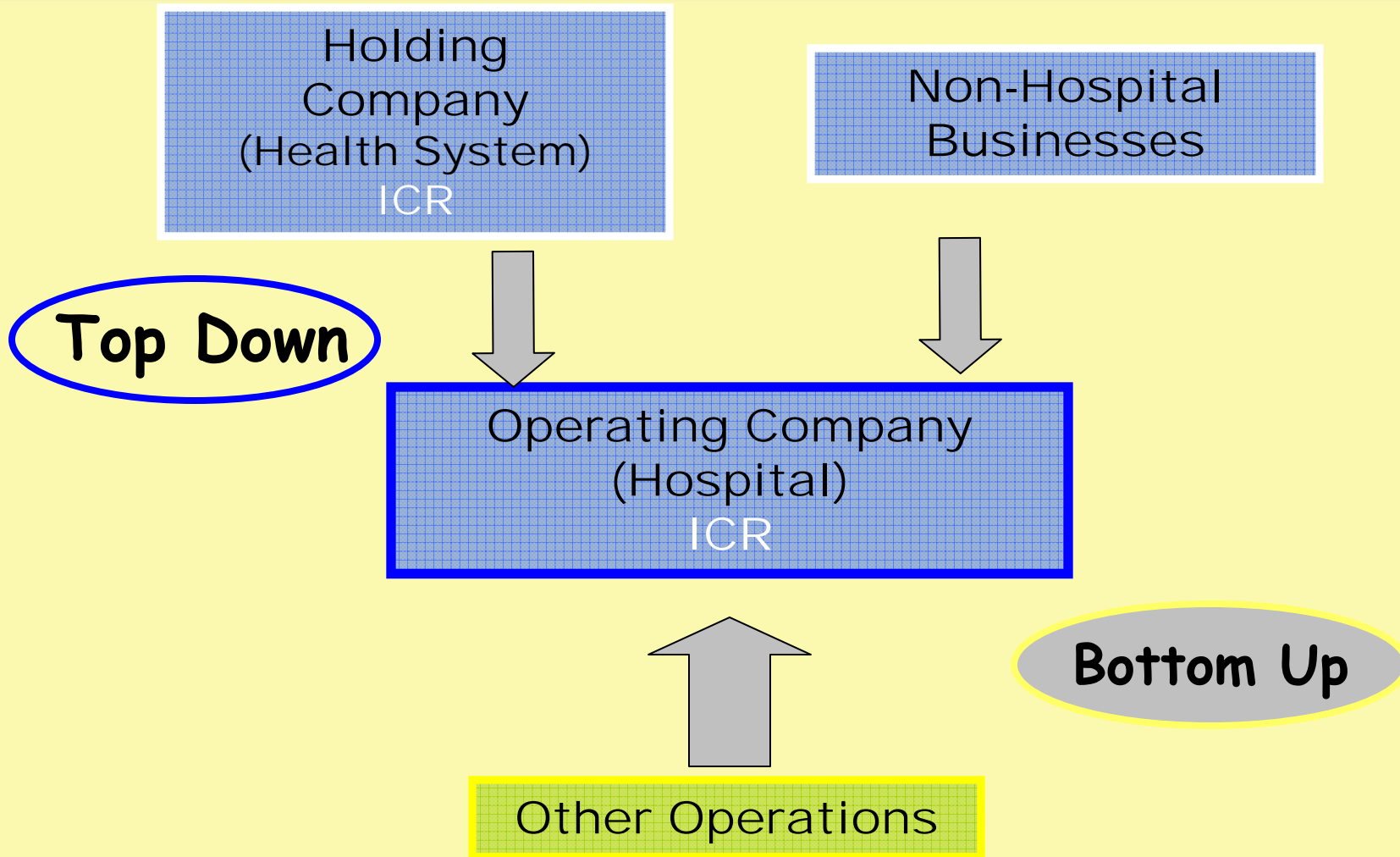
### After The Meeting

- Follow-up information and/or meeting
- Complete analysis
- Peer analysis
- Stress test projections
- Recommendation to rating committee
- Arrive at a rating decision
- Communicate rating and “key drivers”
- Annual report update/ press release

### Ongoing

- Stay fully informed
- Stay in touch with company contact
- Take appropriate off cycle actions
- Conduct industry research
- Perform competitive analysis
- Maintenance of infrastructure/rating tools

# A.M. BEST COMPANY



## Holding Company & Operating Company Analysis

- Key components of Best's Credit Rating evaluation:
  - Balance Sheet Strength
  - Operating Performance
  - Business Profile
  - *Enterprise Risk Management*

## A.M. Best's Rating Evaluation



- Risk management is the common thread that links balance sheet strength, operating performance and business profile...can/should be found in:
  - Strategic decision making
  - Financial management and control practices
  - Daily operating procedures

# Balance Sheet Strength

- **Capital Structure**
  - Debt instruments, covenants, variable vs. fixed, swaps, LOCs
  - Key Ratios: leverage & debt service coverage
  - Capital needs & capital expense
- **Investment Portfolio**
  - Quality/Diversification of assets
  - Pension assets
- **Liquidity**
  - Days Cash on Hand, Cash to Debt

## Operating Performance

- **Revenue composition**
- **Earnings/Profitability**
  - Operating & Excess Margin
    - Impact uncompensated Care, increased interest costs, severance
  - Sustainability
- **Uncompensated Care**
  - Bad Debt Expense
  - Uncompensated Care - % of NPSR
- **Utilization Statistics**
  - Occupancy Rates
  - Physician Alignment
- **Payor Mix**
- **Ability to meet plan**

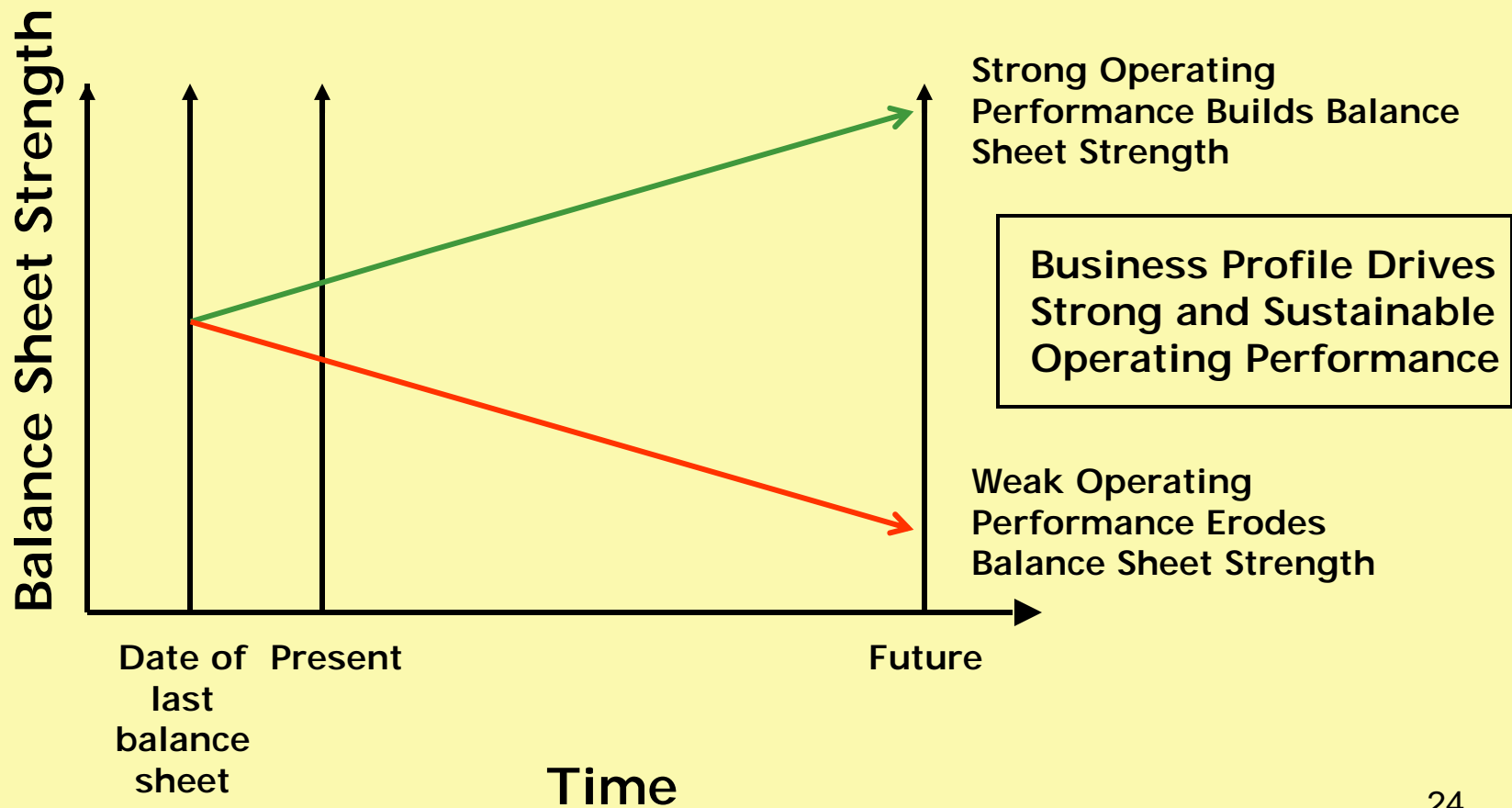
## Business Profile

- **Competitive advantages**
- **Management experience & objectives**
- **Corporate Governance**
- **Market risk**
- **Event risk**
- **Regulatory risk**
- **Service Area Demographics**
  - Median Income Level
  - Population Age 65+
  - Geography, Population Density
  - Insurance Industry  
Concentration: Reimbursement Rates
- **Quality of Care**
  - Hospital Compare Report
  - Patient Satisfaction Report
- **Brand Reputation**
  - Awards and Recognition

## Bringing it all Together

- **Balance sheet strength** is most important
- Sustained, stable **operating profitability** ensures future strength
- Well-diversified, strong **business profile** ensures stability and profitability
- Depth, experience and stability of management influences profile

## Operating Performance and Business Profile Leading Indicators of the Future Balance Sheet



# State of Industry: Review/Preview

# A.M. BEST COMPANY

Market turmoil

Global recession

Housing meltdown



Liquidity crisis

Government bailouts

Rating downgrades

Auction Rate Market Failure

# Capitalization Trends

- Industry had built up excess capital in prior years
- Increased financial leverage due to capital projects & HIT
- Investment Market Volatility
  - Excess capital eroded
- Non-operating losses
  - Investment losses, both realized and unrealized
    - More impairments likely in 2009
  - Under funded pension liability
  - SWAP losses
- Access to capital tight
- Liquidity has been weakened

# Where Are We Now?

- **Still uncertainty in hospital fundamentals....**
  - Sharp hits to bottom line
  - Drain on cash
  - Decreased service offerings
  - Reduced capital budgets/spending
  - Limited access and higher cost of capital
  - Reduced fund raising activity
  - Increased layoffs
  - Strain on employee pensions and insurance plans
  - Increased ED visits, jumps in charity care and bad debt
  - Third Party Payors:
    - Funding cuts (i.e. Medicaid/MediCal)
    - Tougher commercial carrier negotiations
  - Declines in elective procedures (revenues)

# Where Are We Going?

- More regulation likely
- M&A/divestitures may accelerate
  - Larger systems acquiring smaller troubled hospitals
- Emerging investment risks -more impairments?
- Liquidity remains tight
  - Will take time to restore cash positions
- Healthcare Reform: policy/funding – still a big questions?
  - Fee on healthcare providers? Public option? Care/Caid expansion?
- Ratings under pressure

# Key Factors Driving Ratings Today

- Recent rating changes - event driven
- Erosion of Net Assets
  - Earnings pressure
  - Lower inpatient and outpatient revenues
  - Lack of expense reduction efforts
  - Poor physician alignment
  - Market position
  - Significant non-operating losses
    - Investments, SWAPs, Pension under funding
  - Limited financial flexibility
    - Inability to refinance auction rate (early 08)/variable debt

## Key Factors Going Forward

- Focus on preserving capital
- Build liquidity
- Maintain consistent operating profitability
- Corporate governance & management
  - Risk Management:
    - Risk appetite commensurate with capital

Questions ?

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