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Hospital Focus

What Rating Agencies Look for in Independent Organizations

At The Governance Institute's 2022 Forum for Independent Hospitals and Health Systems, Kimberly A. Russel, CEO of Russel Advisors and Governance Institute Advisor, had a fireside chat with Kevin Holloran, Senior Director at Fitch Ratings, around what rating agencies look for in independent provider organizations. This article presents key questions and takeaways from the session.

Fitch's Outlook for the Healthcare Sector

The bumpy ride not-for-profit hospitals have been on will continue. While sector medians show significant credit strength when looking backwards, the future outlook is much more concerning. Elevated expense pressure remains pronounced, particularly for nurses, and even as macro inflation cools, labor expenses may be reset at a permanently higher level for the rest of the year and likely well beyond. Due to this challenging operating environment for hospitals, Fitch sees a deteriorating outlook for the rest of 2022 and into 2023, with a period of elevated downgrades and negative outlook pressure.[1]

Rating Independent Hospitals' Credit?

Who Does Fitch Rate?

Fitch rates hospitals and health systems of all shapes and sizes, from 25-bed critical access hospitals all the way up to large national systems. Around half of the organizations Fitch rates are considered standalone hospitals.[2] The number of standalone hospitals it rates has declined throughout the years and will most likely continue to do so as more independent hospitals partner and join larger organizations.

1 For more on Fitch's sector outlook, see "Fitch Ratings 2022 Mid-Year Outlook: U.S. Not-For-Profit Hospitals and Health Systems," August 16, 2022.
2 Fitch characterizes healthcare organizations as either standalone hospitals (rather than using the term "independent") or systems.

What Metrics Are Most Important to a Rating?

Two metrics that are critical to a hospital's credit rating are:

1. **Cash to debt**: This is the single metric that Fitch keys in on the most when rating an organization's credit. While hospitals often like to focus on days cash on hand, it is not as meaningful to Fitch as cash to debt, although it does quote this metric as well. The balance sheet will give hospitals stability, time to transform, and time to ride through the rough patches we are in right now.
2. **Market essentiality** (also known as market density): This is also a key credit factor and determines if hospitals are a market-maker or a price-taker. For example, larger health systems may look at their market and ask, "Do we need 27 hospitals in this market or do we need five or six where the densest populations are?" Independent hospitals, almost by their very nature, have that density, which can give them leverage with payers and make them a "must have" in the community.

Does Size and Scale Affect an Organization's Credit Rating?

While many independent organizations may be concerned about how their size will affect their credit rating, Fitch does not penalize for smaller size and scale, nor does it reward for larger size and scale. There is a strong correlation between the size of a provider and the strength of their rating, but this is not a top rating factor. When rating a hospital, the rating committee only considers if the organization's size and scale helps or hurts the hospital in some shape or form that they should factor into the rating.

Exhibit 1 shows the fiscal medians by rating category for 2021, comparing standalones and systems. Overall standalones tend to have just as strong ratings as systems. When looking at metrics such as operating margin, operating EBITDA margin, and excess margin, standalone hospitals' medians are shown to be stronger than systems on average. While systems have some higher medians in the top rows related to liquidity and leverage, the only metric that is notably higher is days cash on hand.

The top takeaway from this is that being independent does not have an adverse effect on the quality of an organization's metrics. In fact, some of the standalones that are well-positioned in their market have just as strong ratings as the large national systems.

Exhibit 1: Fiscal 2021 Medians by Rating Category

Standalone	2021	2020	2019
	104	99	97
Days Cash on Hand	237.5	232.1	213.3
Days in Accounts Receivable	46.2	44.4	46.2
Cushion Ratio (x)	24.7	23.3	21.7
Days in Current Liabilities	89.4	88.1	61.2
Cash to Debt (%)	179.7	150.5	157.6
Cash to Adjusted Debt (%)	175.7	135.8	131.7
Operating Margin (%)	3.8	1.7	2.0
Op EBITDA Margin (%)	9.7	8.4	8.7
Excess Margin (%)	7.0	3.7	3.8
EBITDA Margin (%)	13.0	10.4	10.6
Net Adjusted Debt to Adjusted EBITDA (%)	-1.6	-1.6	-1.0
Personnel Costs as % of Total Operating Revenue	53.1	55.1	54.4
EBITDA Debt Service Coverage (x)	5.2	4.1	3.8
OP EBITDA Debt Service Coverage (x)	3.8	3.1	3.0
Maximum Annual Debt Service as % of Revenues	2.5	2.7	2.6
Debt to EBITDA (x)	2.5	3.4	3.2
Debt to Capitalization (%)	29.7	32.6	32.8
Average Age of Plant (Years)	12.3	12.0	11.7
Capital Expenditures as % of Depreciation Expense	101.2	108.4	107.0

Systems	2021	2020	2019
	115	114	106
Days Cash on Hand	270.4	255.0	230.2
Days in Accounts Receivable	47.7	44.6	46.8
Cushion Ratio (x)	31.7	29.0	26.5
Days in Current Liabilities	89.8	95.0	66.8
Cash to Debt (%)	189.4	169.9	165.7
Cash to Adjusted Debt (%)	185.0	161.1	149.9
Operating Margin (%)	2.7	1.3	2.5
Op EBITDA Margin (%)	8.1	6.7	8.9
Excess Margin (%)	6.1	3.1	4.9
EBITDA Margin (%)	12.1	8.5	10.6
Net Adjusted Debt to Adjusted EBITDA (%)	-2.5	-2.6	-1.5
Personnel Costs as % of Total Operating Revenue	52.3	55.0	53.0
EBITDA Debt Service Coverage (x)	5.8	3.9	4.5
OP EBITDA Debt Service Coverage (x)	3.8	3.2	3.7
Maximum Annual Debt Service as % of Revenues	2.1	2.2	2.2
Debt to EBITDA (x)	2.8	4.4	3.4
Debt to Capitalization (%)	31.9	35.2	32.9
Average Age of Plant (Years)	11.8	11.4	11.5
Capital Expenditures as % of Depreciation Expense	99.4	110.1	125.0

Potential "Red Flags"

Board members of independent hospitals should be on the lookout for several "red flags" at their own organizations, including:

- **Flat or declining year-over-year net patient revenues** (minimal or negative growth): If your organization starts to lose the "it" factor in your market and patients are not coming anymore, this can be very difficult to solve.
- **Resistance to change**: Today it is necessary for hospitals to be able to adapt and change. Leadership cannot have a "this is the way we have always done things" mindset if they want to succeed in the market. When evaluating an organization's resistance to change, Fitch considers its long-term relationship with the organization including what the organization has been through and what it has done to survive and thrive in tough times.
- **Once change begins, being too slow to execute change**: Change initiatives need to keep moving forward at a steady pace.
- **Unwillingness to course correct**: It is critical for boards and senior leaders to realize when a mistake is made or the organization is moving in the wrong direction and to take action and move forward on a new path.
- **Sudden industry change that forces added expenses onto a provider** (e.g., staffing): These type of events can be especially challenging for smaller organizations that have less of a balance sheet to effectively deal with the financial impact of added expenses.

Board Takeaways

This has been a challenging year for hospitals. Currently, roughly half of Fitch's credits are negative operating margins. Workforce challenges have been the biggest differential with hospitals struggling to manage staff shortages and increasing labor costs. The good news is that most hospitals are working on initiatives to solve workforce challenges, and some are already starting to turn the corner and see the benefits of these efforts.

From a strategic perspective, there are several actions boards and senior leaders can take to ensure they are effectively governing their organizations:

- **Stick to your mission**. Kodak was once the most-trusted brand in America. Its original mission was "the preservation of memories." The company invented the digital camera, but the board made the decision not to move forward with digital photography and instead pivoted to a chemical and paper company. Soon after, digital photography took over. Had leadership embraced the change and stuck to the organization's mission, Kodak would still be at the top of their industry today.
- **Adopt "no regrets" strategies.** Think about what strategies are important to embrace under any circumstances and work towards those (e.g., strive to have a strong balance sheet, market density, great relationships with payers, engaged physicians, etc.). These strategies will only make the hospital stronger and in a better position to succeed.
- **Consider partnerships.** Think strongly about partnering if the right opportunity comes up. Thoroughly weigh the pros and cons and think through whether the partnership would help the organization better achieve its mission and serve its community.
- **Be prepared for staffing challenges to continue**. It will likely be two years before some level of "normal" returns to the sector in regards to staffing—possibly more or less depending on a hospital's market.
- **Know your bond documents**. Fitch is wary of covenant violations as fiscal 2022 audits are completed. Covenant violations could easily continue into 2023.

Stay tuned for more presentation summaries and videos from The Governance Institute's 2022 Forum for Independent Hospitals and Health Systems.