

## **How Bond Rating Agencies Look at Institutional Credit Factors**

**Bruce Gordon**

**Senior Vice President, Moody's Investors Service**

“Not a single hospital in the United States is Aaa rated by any of the bond rating agencies,” reported Bruce Gordon, Senior Vice President, Moody's Investors Service. Mr. Gordon spoke at a March 5 Governance Briefing, *How Bond Rating Agencies Look at Institutional Credit Factors*, organized by the University of Pittsburgh's Health Policy Institute. In contrast, he noted that nearly 3,000 (6 percent) public finance institutions, including cities, counties and municipalities are Aaa rated. Gordon attributes lower bond ratings for healthcare institutions partly to the highly regulated and uncertain nature of the healthcare industry. “Despite the recent emergence of certain positive factors, we believe the healthcare industry outlook has turned negative... and will face more downside credit pressure... over the next one to two years,” Gordon stated, summarizing Moody's not-for-profit healthcare outlook.

Flattened expected patient volume growth, expenses growing faster than revenues, cuts in Medicaid reimbursement, increased capital needs of the hospitals, and management turnover all support a negative industry outlook. On the other hand, Gordon pointed to several encouraging indicators: Medicare reimbursements are set to become more favorable with the passing of the drug reform bill; the economy is improving, leading to a higher return on hospital investments; cost-controlling, especially employee compensation and revenue cycle improvements, are leading to more cash generation; and

the slowdown in competition faced by not-for-profit hospitals from niche providers are all positive factors.

In 2003, for the first time the bond rating of a children's hospital dropped to a non-investment grade of Ba2. Gordon explained that although many rating downgrades are self-inflicted, usually caused by poor decision making by the board and senior management, additional reasons for downgrades may include mergers and acquisitions, non-core operations, construction-related dislocation, capitation, management/physician turnover, or merger dissolution. Some local market explanations for downgrades Gordon cited include a large Medicaid and indigent mix, nursing and other staff shortages, unfavorable demographics, volume softness, competition, high managed care payer mix, or union actions. Financial reasons for downgrades include wage increases/agency labor, pension expense/funding, malpractice expense, stock market losses, incremental debt/capital spending, or accounts receivable, contractual, or collection problems. Gordon cautioned that the impact of a downgraded rating may be immediate or it may seem negligible, but inevitably the impact will be reflected eventually in a higher interest rate for the institution.

“There is little a hospital can do to improve ratings if it is stuck in an area with unfavorable demographics,” said Gordon. In contrast, he pointed out factors such as good demographics/population growth, exclusive services/specialty provider, sole community provider, cost cutting initiatives, acquisition by a higher-rated entity, improved reimbursement contracting, patient volume increases, increased market share, divestiture of unprofitable operations, or digestion of mergers that can justify a rating upgrade.

Moody's generally looks at a 5-year trendline when assessing a rating, taking into consideration how the organization compares to peers and whether cash flow sufficient for the needs of the system is being generated. If Moody's is aware of trouble, but a strategy is in place to remedy the problem, the institution usually is granted some breathing room. However, 3 plus consecutive years of problems would most likely be cause for downgrading.

Gordon interacts with 70-80 institutional healthcare boards each year and is happy to meet board members who know the strategy of their institution and consider where it will be in the next few years. More often than not, he believes not-for-profit board members do not challenge management or engage in sufficient oversight of operations. He advised board members to be more discerning, do some detective work, and encouraged them to question the numbers. Gordon asserted that effective governance can contribute to a ratings outcome, particularly on the margin to improve conditions.

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*03/09/2004*