ABC's & 123's of Bond Ratings

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HEALTH CARE PRACTICE

Today's Objectives

- Learn about the role of rating agencies
- Understand how healthcare organizations are evaluated their "credit profile"
- Apply learning in a group exercise

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What is a credit rating?

- A Credit Rating is an ***opinion of a borrower's ability and willingness to pay its financial obligations when due***, its "credit worthiness."
- A Credit Rating incorporates ***independent and objective analysis*** of information provided by the borrower ***using established criteria.***

Most Importantly, a credit rating influences access to capital markets and the cost of financing.

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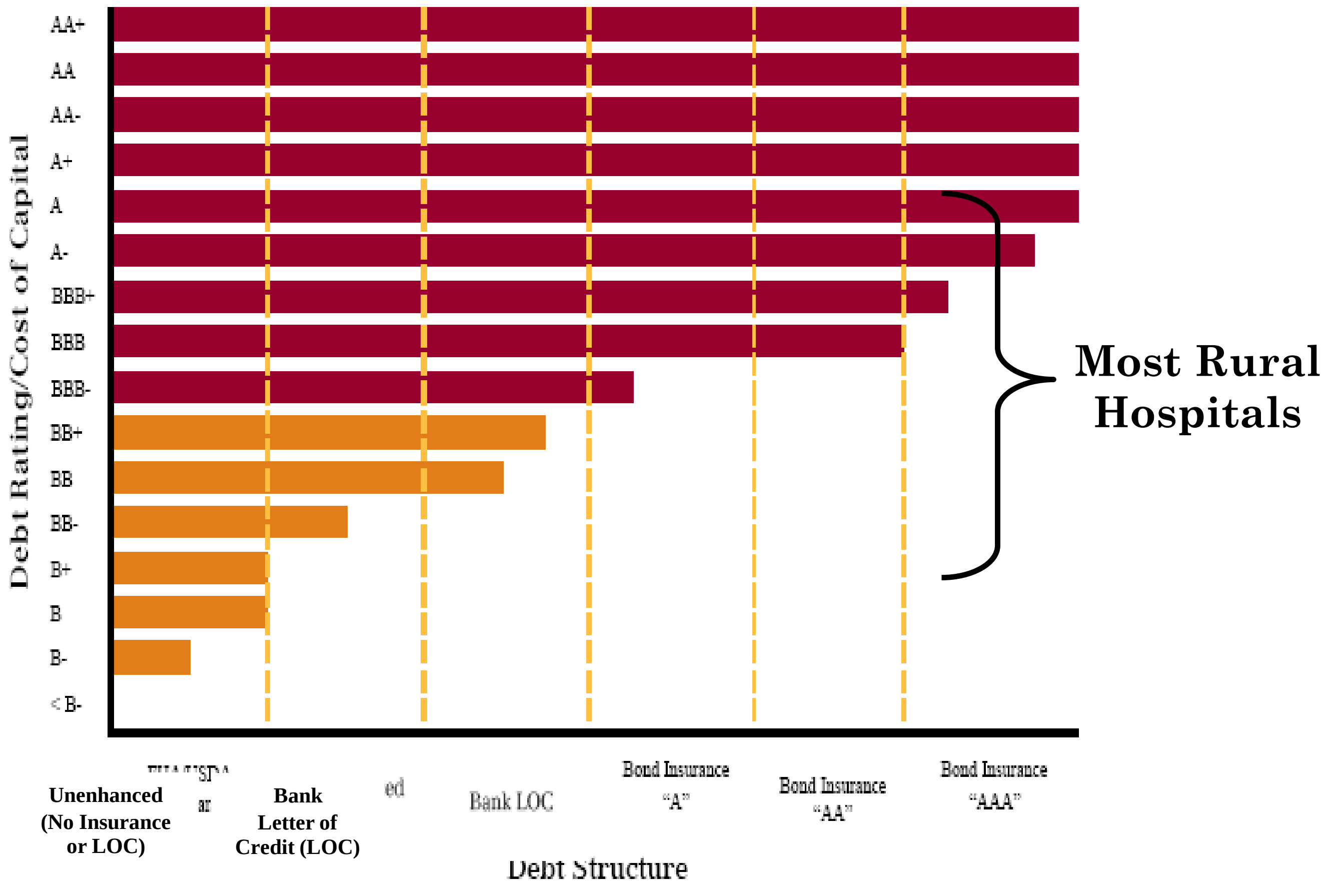
Who are the rating agencies?

STANDARD
&POOR'S

FitchRatings
KNOW YOUR RISK

Why are ratings important?



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What are rating implications?

- Higher financing fees
- Track record of financial performance
- Sources of funds must be secure
- Stricter covenants
- More frequent and detailed disclosure
- More oversight by the lender/bondholders

Forecasts must be conservative

How rates are determined?

X%

+

Y%

=

Z Rate%

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How rates are determined?

X% =

INDEX

- Prime Rates
- Federal Home Loan Bank
- Municipal Market Data (MMD)
- Treasuries

Index Rate: Perspective

KEY INTEREST RATES

	Today 10/9/2017	Last Week 10/2/2017	Last Month 9/11/2017	Last Year 10/10/2016
Federal Funds Rate	1.25	1.25	1.25	0.50
Prime Rate	4.25	4.25	4.25	3.50
LIBOR (1 month)	1.24	1.23	1.24	0.53
LIBOR (3 month)	1.36	1.34	1.32	0.87
SIFMA	0.92	0.94	0.78	0.87
SIFMA/1 M LIBOR %	74.4	76.2	63.1	164.3
B.B. 20 Bond Index	3.63	3.64	3.49	3.20
B.B. Rev. Index	3.84	3.85	3.70	3.38
30-Day Visible Supply	8.6 B	9.2 B	10.4 B	16.0 B

- **Index rates have risen approximately 75 bps since last year at this time**
- **Interestingly the amount of debt being issued has also declined**

How rates are determined?

Y% =

CREDIT SPREAD

The extra charge of the risk associated with credits of your same caliber that the market is demanding

Spreads are determined by combination of Quantitative and Qualitative factors

What is the Difference in Credit Spreads?

GENERAL OBLIGATION TAX-EXEMPT BOND MARKETS

Year	AAA Tax-Exempt	Current Tax-Exempt Credit Spreads			1 Month Ago Tax-Exempt Credit Spreads			1 Year Ago Tax-Exempt Credit Spreads		
		AA	A	BBB	AA	A	BBB	AA	A	BBB
1	0.94	0.03	0.21	0.48	0.01	0.19	0.46	0.04	0.17	0.42
5	1.37	0.11	0.41	0.72	0.07	0.37	0.68	0.11	0.36	0.66
10	2.02	0.20	0.53	0.88	0.19	0.52	0.87	0.23	0.53	0.81
20	2.64	0.22	0.53	0.86	0.22	0.53	0.86	0.26	0.57	0.79
30	2.83	0.22	0.53	0.85	0.22	0.53	0.85	0.27	0.57	0.77

Spreads vary over time, but right now the difference between AAA and AA is 3 bps and the difference to BBB is 48 bps
That's called a "steep" yield curve

Quantitative Factors

Y% ±

- Operating Performance
- Financial Ratios
- Cash Flow Ratios

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Quantitative Factors

	Formula
Income Statement/Operations	
Operating margin (%)	(Operating revenue - Operating expense)/Total operating revenue
Excess margin (%)	(Operating revenue - Operating expenses + nonoperating income)/(Total operating revenue + nonoperating revenue)
Operating cash flow margin (%)	(Operating revenue - Operating expenses + Depreciation &Amortization + Interest expense)/Total operating revenue
EBIDA Margin (%)	(Operating income + Interest expense + Depreciation & Amortization)/Total operating revenue
Balance Sheet Strength	
Days cash on hand (x)	(Unrestricted Cash & Investments)/((Total expenses - depreciation & amortization)/365)
Cushion ratio (x)	(Unrestricted Cash & Investments)/(Estimated Peak principal payments + Peak Interest expense)
Cash-to-debt (%)	(Unrestricted Cash & Investments/Total debt)
Days in accounts receivable	(Unrestricted Cash & Investments/Total debt)
Capital-Related Ratios	
Annual debt service coverage (x)	(Excess of revenue over expenses + Interest expense + Depreciation&Amortization)/(Debt principal payments + Interest expense)
Debt-to-capitalization (%)	(Long-term debt + short term debt)/(Long-term debt + short-term debt + Unrestricted net assets)
DB pension funded status (%)	((Long-term debt + projected benefit obligation-fair value of plan assets))/(unrestricted net assets + (long term debt + projected benefit obligation -fair value of plan assets)))*100

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Qualitative Factors

Y% ±

- Physicians
- Market
- Management
- Government Guarantee
- Governance
- Organizational Structure
- Preparedness for Healthcare Reform
- Strategic value/financial return on project

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Qualitative Factors in Credit Assessment

Qualitative factors provide context & can mitigate average or below average financial ratios.

Physician Complement	– How many on staff, of what age, and specialty – Number of physicians who drive admissions (i.e., dependency or vulnerability if small number)
Market	– Population size - growing and/or aging? – Payor mix – Employer base – Competitors
Management	– Experience/salary/tenure – If good, how long is their contract – Financial performance under their watch

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Qualitative Factors in Credit Assessment

Stricter underwriting standards have put new emphasis on the qualitative component of credit assessment.

Governance	– Board tenure – Back-up plan to implement in the event of financial challenges – Financial performance under current board
"Preparedness" for Health Care Reform	– EHR – Quality scores – Collaboration with other providers
Strategic Value/ROI	– Will the result of this project generate additional revenue? – If this project is for strategic purposes, clearly articulate the expected benefit

Things Change

Moody's downgrades Lucile Packard Children's Hospital's credit rating
Written by Alia Paavola | August 01, 2017

Moody's Investors Service downgraded Palo Alto, Calif.-based Lucile Packard Children's Hospital's credit rating to "A1" from "Aa3."

Additionally, Moody's assigned its "A1" rating to Lucile Packard Children's Hospital's proposed $200 million series 2017A revenue bonds, issued by the California Health and Finance Authority. The bonds will mature in 2057.

The downgrade is a result of several factors, including LPCH's 32 percent increase in debt due to the new bonds, poor operating performance, challenging payer mix, increased spending from an expansion project and temporary reduction of high revenue services. Moody's also acknowledged the hospital's healthy balance sheet, strong market position, affiliation with Stanford University and favorable revenue growth.

The outlook is stable, reflecting Moody's expectation that the hospital will see improved operating performance and balance sheet metrics in fiscal year 2018 to offset the heavy debt load.

Things Change

S&P, Moody's Give Atlantic Health System Highest Health System Rating in NJ

August 2017, Morristown, NJ – Atlantic Health System, a leading health care delivery system in New Jersey, is once again the highest-rated New Jersey based system rated by credit agencies Moody's and S&P.

Moody's raised its rating for the health care organization from A1 to Aa3, the highest rating among all health care systems in New Jersey, with an outlook of "stable." The rating upgrade reflects Atlantic Health System's continued stability of operating performance and financial growth of the balance sheet, as well as its favorable market position and the "wide array" of services it provides. The credit agencies noted the following among the reasons for Atlantic Health System's enviable ratings and outlook:

- *The rapid growth and increased integration of Atlantic Medical Group, which now includes more than 900 community-based physicians and other providers.*
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- *Continued growth in operating margins, cash measures and debt leverage measures*

S&P noted Atlantic Health System's significant additions of several key leadership roles covering patient experience, integrated care delivery, and innovations and technology following the addition of President and CEO Brian Gragnolati in 2015. The agency also highlighted Gragnolati recently being named chair-elect designate of the American Hospital Association. He will assume the board chairmanship in 2019.

Key Factors in a Rating Change

Increase in debt

Significant reduction in liquidity or financial performance

Unfavorable changes in Medicaid payments

Acquisition or affiliation that is materially dilutive to the balance sheet or operating performance

Reduction in market share

Significant improvement in leverage metrics

Maintenance of liquidity and operational performance in order to support the large debt burden

Summary Points

- Diligence in planning is essential to accessing capital
- The qualitative factors are becoming increasingly important in your ability to access the market
- Proactive management of your image can affect how much you pay in interest rate
- It's helpful to know your "credit profile" and utilize key rating agency metrics to monitor performance

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