

Rating Health Care

Overview of the methodical credit rating assignment
to hospitals, psychiatric clinics, and nursing homes in the health care sector

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Introduction

In 2019, the hospital landscape in Switzerland comprised 281 hospitals. These are divided into 142 acute hospitals, 53 rehabilitation clinics, 17 birth centers, 19 specialist clinics and 50 psychiatric clinics. The 20.1 million outpatient consultations accounted for CHF 8.4 billion, which corresponds to around 27% of hospital costs. Inpatient hospital stays amounted over 1.5 million cases. In general, there is a trend towards shortening the length of inpatient stays and in some cases a shift from inpatient treatment to outpatient procedures. With about 38,000 beds and 171,000 employees (in full-time equivalents), the hospital sector generated added value of over CHF 31.5 billion. This corresponds to around 4.3% of Switzerland's gross domestic product (GDP).

With the introduction of the major hospital reform on January 1, 2012, Swiss hospitals were exposed to tougher competition in the provision of basic care. The greater competitive pressure is manifested both in the provision of services and in the autonomous financing of services by so-called listed, contract, or be-out-hospitals (Ausstandsspitäler). The Swiss

hospital landscape can alternatively be divided into the following four categories of service providers:

- **University Hospitals**
- **Cantonal hospitals**
- **Regional Hospitals**
- **Private hospitals**

This sector documentation provides a brief overview of the various rating-relevant aspects of hospital's credit rating assessments. Furthermore, the most important elements of the new hospital financing from the perspective of a credit rating agency will be summarized at the beginning.

Hospital Financing Since 2012

The financing system in place since 2012 is based on performance-related flat rates, so-called case rates. These are distributed according to the SwissDRG tariff system. Among other things, this is intended to implement the requirements of true-cost pricing (bench marking) and quality. The aim of

the hospital financing system is no longer to finance hospitals as institutions, but to finance their services to patients.

The cantons have been assigned various tasks, duties, and competencies, including the keeping of cantonal hospital lists. Public or private hospitals that are included on the hospital list receive cantonal contributions towards the costs of medical treatments. The new hospital financing system defines the division of costs between the cantons (minimum 55%) and health insurance companies (maximum 45%). Whereas the public sector used to finance hospital buildings and facilities before 2012, the corresponding costs are now covered by hospital revenues. In addition, hospitals were generally obliged to cover their financing or investment needs independently on the credit or capital markets.

The latter aspect in particular has led to some need for adaptation and the development of appropriate know-how in the various management and executive bodies of hospitals. Whereas in the past, the cantons normally took over the provision of capital for public hospitals or procured outside capital in their own name and acted as counterparties, it is now the hospitals that have to or would have to cover their financing needs independently on the credit and/or capital markets. Conversely, hospital financing is a welcome alternative for many investors.

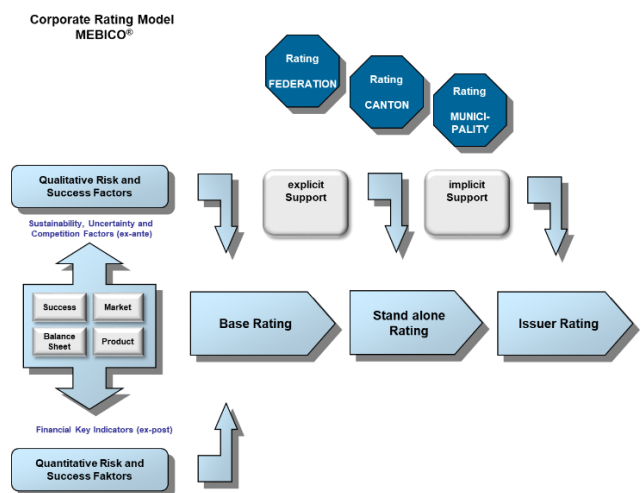
While some cantons revised their hospital strategy some time ago, reducing the number of hospitals and thus preparing themselves for competition and the free choice of hospital, corresponding efforts in other cantons were not successful or have not even been initiated yet. In addition, infrastructure investments that are often postponed require modernization, which should also optimize processes and result in increased efficiency. Optimal orientation towards patient needs, coupled with technological progress, requires a future-oriented investment policy and ultimately additional capital requirements.

Credit Rating Concept

The credit rating model is designed as an expert system and, thanks to its modular structure, takes account of the fact that the creditworthiness of public sector companies is determined both externally (exogenously) and internally (endogenously). In a first step, the exogenous credit rating factors are systematically analyzed, identified, and evaluated. In a second step, the endogenous creditworthiness factors are assessed using quantitative and qualitative factors (see also Figure 1).

Credit Rating Architecture

In contrast to credit ratings of private companies, the conceptual distinction between stand-alone rating and issuer rating is significant in the segment of public sector companies. While the stand-alone rating considers any explicit guarantees by third parties, the issuer rating can benefit complementarily from implicit support from the public sector as owner or sponsor of an institution.



1 Assessment of creditworthiness of public sector companies

It is worth noting that public sector companies, in awareness of existing guarantees, often have significantly worse financial ratios than comparable private sector companies. In particular, the regularly observed zero-profit-condition is reflected in lower balance sheet ratings. Due to the basic service mandate character of public sector companies, this is

also partly the case when assessing the creditworthiness of hospitals.

Financial support from the public sector is still very important in the hospital sector. It is true that the intention of the new hospital financing is that the cantons will no longer make any contributions in excess of the case rate payments mentioned above. In reality, however, some cantons have introduced a variety of liability, deficit, and financing guarantees in legislation. Conversely, many cantons are adhering to the requirements of the new hospital financing, which is why there are currently significant imbalances between cantonal regulations. It is therefore particularly important - as is generally the case with all state-affiliated companies with performance contracts from the public sector - to systematically assess any explicit guarantees and/or implicit support from the public sector as the owner or sponsor of a hospital in a first step.

Credit Rating Methodology

Rating assignments' methodological foundation is an asymmetrically extended Logit function, which realistically reflects the dynamics of credit risks. In particular, it allows consistent consideration of the financial and legal interdependence within the public sector as the owner of an institution by means of various parameters and indices. The methodological system allows a risk-adequate and objectively directly comparable credit assessment of hospitals in different cantons.

For example, the assignment of different issuer ratings to two hospitals from cantons x and y may be justified despite a similar current financial situation if the institutional framework conditions in canton x significantly reduce or increase the probability of default compared to those in canton y.

Rating Criteria

As with any sound credit assessment, both quantitative and qualitative elements are assessed when assigning a corporate rating to a hospital.

Quantitatively, the credit risk is identified, analyzed, and evaluated on the basis of hospital-specific key figures from balance sheets and income statements of past years (ex-post situation). This provides an objective picture of autonomous financial management in comparison with other hospitals.

Qualitatively, the credit assessment is supplemented by various risk and success factors that exert a systematic influence on the future development of the credit risk (ex-ante trend). These primarily include institutional framework conditions and structures of the hospital as well as any incentives for sustainable financial management.

Qualitative Rating Criteria (Base Rating)

Qualitative risk and success factors are systematically identified and assessed by the Rating Committee. Within the scope of the rating process, matters in four areas of the qualitative rating criteria for hospitals (not exhaustive) are of fundamental relevance to creditworthiness:

Institutional framework

- Market structures and barriers to competition
- Legal compensation and financing regime
- Strategic risk profile of the company

Corporate structure and strategy

- Complexity of the corporate and business structure
- Sustainability of the corporate strategy
- Effectiveness of corporate governance

Accounting and informational content

- Accounting and disclosure standards
- Balance sheet structure and valuation practice
- Expected development of leverage

Competitive position and market environment

- Location, geographical catchment area of patients, and competitive situation (regional, cantonal, if necessary national, international)
- Infrastructure and investment planning
- Bed occupancy, case numbers, and patient growth
- Privately vs. generally insured patients' ratio
- Additional offers and diversification
- Strategy design (universal strategy, niche strategy, etc.)
- Quality management and reputation

Quantitative Rating Criteria (Base Rating)

The systematic identification and evaluation of the current financial situation is carried out in the form of a balance sheet rating. Within the scope of the rating process, three creditworthiness-related issues in the financial autonomy and sphere of influence of a hospital (without completeness) are fundamentally relevant:

Assessment of capital structure and indebtedness

- Debt burden and coverage
- Net interest charges
- Debt financing structure and potential
- Asset coverage ratios
- Assessment and evaluation of the liability substrate (usability of the properties for alternative purposes, etc.)

Assessment of earning power and profitability

- EBITDA margin
- Cash flow profitability
- Total capital return
- Depreciation rates
- FFO margin

Assessment of cash flow potential

- Operating cash flow
- Free cash flow
- Cash flow margins

Outlook

It is safe to assume that numerous adjustments such as hospital closures and mergers will continue to change the Swiss hospital landscape in the future. Regional hospitals, in particular, are currently facing stronger competition than cantonal hospitals. In addition, further adjustments will be necessary to the SwissDRG tariff system (for example, with regard to flat rates for children's hospitals or the introduction of flat rates in outpatient care), which is not yet fully developed and needs to be improved. A continuous reform process in the regulatory environment of the healthcare sector can therefore be expected in the future.

Moreover, it cannot be ruled out that cantons that already largely meet the requirements of the new hospital financing system will build up pressure at the federal level accordingly to prevent the deficit and liability guarantees established in other cantons. In doing so, they want to prevent cantons that have so far been inactive in this area from continuing to provide their hospitals with explicit liability and deficit guarantees, thereby distorting the real creditworthiness situation. When assessing creditworthiness in the healthcare sector, it is therefore essential to pay attention to current developments in the regulatory and political environment and to reflect the corresponding risks in credit ratings.

This also becomes apparent during the Corona pandemic, which leads to postponements of elective interventions and additional expenses at many hospitals. For the Swiss hospital landscape, losses of up to 2 billion Swiss francs are expected for 2020 (source: Spital-Benchmark). A variety of financial support measures have been signaled by some cantons but the participation of the federal government in compensation payments is still uncertain. The expected compensation payments will most likely not be sufficient across the board to avoid financial loss statements for the 2020 financial year. This is expected to be reflected in weaker financial risk profiles and reduced internal financing strength.

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