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Ellwood Viewpoint

Healthcare Financial Management Association's Annual National Institute 2017 Recap

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Note from Tim Egan: Each year, I attend the Healthcare Financial Management Association (HFMA) Annual National Institute (ANI). As Ellwood's investment consulting Hospitals and Healthcare Practice Leader, my HFMA membership and attendance is predicated on trying to remain apprised of and keeping informed about the major implications of healthcare reform and other prevalent developments that impact our hospital and healthcare clients' investment programs.

The following summarizes key highlights from HFMA's leadership address and Fitch Ratings': Rating Agency Update. Feel free to distribute this recap internally at your organization or send externally to anyone you think might find it useful.

Collaborate for the future

The central theme of ANI this year was to "collaborate for the future." HFMA President and CEO Joe Fifer stressed the need to build collaborative relationships at all levels of healthcare to deliver the resources and services required to serve our communities. Mr. Fifer noted that collaboration is not easy and requires commitment, communication, empathy, and even, at times, a sense of humor. However, when collaboration is employed, "something magical happens in our industry."

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Many of the conference's educational sessions echoed Joe's collaboration theme.

HFMA leadership address

Mary Mirabelli, Vice President - Global Healthcare Services for Hewlett-Packard Enterprise Services served as HFMA's Chair for 2016-2017. During her leadership address to ANI attendees, Ms. Mirabelli recapped her year as Chair and reaffirmed her theme: "Thrive." During a time of great change, "Thrive" emerged as a theme because she sees HFMA as being a credible leader in building a "thriving, sustainable healthcare system" due to the membership's resiliency in the face of change.

At the end of her address, Ms Mirabelli introduced Carol Friesen as HFMA's new national Chair for 2017-2018. Ms Friesen currently serves as Vice President of Health System Services at Bryan Hospital in Lincoln, Nebraska and has been a member of HFMA since 1999, serving in many board positions.

Ms Friesen began her remarks by saying that our country is in the midst of a "stewardship dilemma." Who is responsible for healthcare; our delivery system, insurance companies, government, society, or patients? She posed the question to HFMA members, "Why not start with us?" She recalled former HFMA chair Melinda Hancock's 2015-2016 theme: "Go Beyond." Ms Friesen implored HFMA members to go beyond their comfort zone as stewards of healthcare resources and become stewards of lives and relationships. Each patient has a face, a name, and a unique story and it's important that we recall, as those serving patients, that we are working with humans and not numbers.

Ms Friesen's passion for healthcare advocacy isn't by accident. Her purpose is very much rooted in personal experience and during her address, she shared three of those personal stories:

- At a young age, her brother sustained significant injuries and endured a long recovery after being hit by a semi-trailer while riding a three-wheeler.

- Long-term medical issues like cancer, arthritis, and heart problems plagued her father-in-law. His end-of-life wishes were for no extreme measures to occur. Rather, he hoped to “go home” according to his religious faith. This wish presented difficulties for family to honor.

- An uncle who had extreme mental health issues resulting from manic depression. His medical issues impacted his extended family.

These stories fuel Ms Friesen’s healthcare advocacy and her passion and purpose goes well beyond her job title. For that reason, Ms Friesen announced her theme for the year: “Where Passion Meets Purpose”. This advocacy centers on “taking care of the people who take care of patients.” This means providing the tools, resources, and support necessary to carry out the healthcare mission in our communities.

Ms Friesen recalled Bryan Hospital’s namesake, William Jennings Bryan who said, “Destiny is not a matter of chance; it is a matter of choice. It is not a thing to be waited for, it is a thing to be achieved.” As healthcare finance leaders, she implored HFMA’s members to embrace William Jennings Bryan’s words as a rallying cry in the pursuit of achieving our healthcare mission. She noted that only then will passion meet purpose.

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Featured speaker session review: Rating Agency Update

Mark Pascaris, Director, U.S. Public Finance, Nonprofit Healthcare and Education and Nonprofit Institutions, Fitch’s Healthcare Ratings. All data cited was part of Mr. Pascaris’ presentation at ANI.

Mr. Pascaris discussed Fitch’s healthcare sector outlook and the challenges given the shifting landscape of the ACA and AHCA. He also presented information on Fitch’s rating methodology and its current medians for various financial metrics.

Key Takeaways

- Fitch assigns a “stable” rating outlook while at the same time assigning a “negative” outlook for the non-profit hospital and healthcare system sector.

- The transition from a fee-for-service to a quality-based reimbursement model will take a long time to unfold. From a ratings agency and risk dynamic perspective, the better managed hospitals seem to understand that a “parallel universe” will exist for a long time.

- Data is increasingly becoming a differentiator among providers. However, the proliferation of data is a key challenge. Better managed and better financed hospitals have the tools and the ability to synthesize data and produce useful analytics that can drive decision making and improvements. Those who can effectively manage the data – and drive results – will be able to differentiate themselves.

Fitch’s rating methodology

Fitch currently rates 246 non-profit hospital and healthcare systems. The median rating is ‘A’ with approximately 70% rated ‘AA’ or ‘A’. Slightly over 7% of Fitch’s ratings represent below investment-grade credits. Credits that are rated ‘A-‘ and above are re-rated at least every two years and those rated ‘A-‘ and below are re-rated annually.

Fitch segments its rating methodology into four distinct criteria:

1. Governance and Management

2. Operating Profile

3. Operational Effectiveness

4. Financial Profile/Sufficiency of Financial Resources

1. Governance and Management

Mr. Pascaris indicated that governance and management is perhaps the most important, yet most difficult segment to assess. Fitch’s teams hold a two hour meeting where their objective is to properly access the key strategic initiatives the organization is undertaking and determine if the overall risk profile would likely increase or decrease.

Governance is a key factor. Fitch encourages a board member or two to attend the annual or bi-annual meetings in order understand Fitch’s thoughts on management effectiveness. This is especially important the first time Fitch meets with a hospital and when a hospital is struggling. This provides board-level insights regarding overall strategy, direction, and how long of a leash a board will have with an operating management team.

Fitch's assessment of hospital management teams spans the spectrum from those that can sell the strategy well, but don't execute as effectively to those that may do a poor job of selling the strategy but execute well. As such, Fitch attempts to understand the next two- to five-year direction of the hospital from an operational budget and capital projection perspective. Fitch expects management to have a comprehensive understanding of the balance sheet risk in terms of investment, debt, and derivatives (swaps). When a CFO defers questions about the balance sheet to an advisor during a meeting with Fitch, it raises red flags to the agency.

2. Operating Profile

This assessment focuses on trends in overall market, market share, and long-term capital needs. In general terms, Fitch reports that size matters. It's viewed positively when hospitals with a larger geographic footprint can spread risk. Critical factors in the analysis include the underlying quality of a hospital's service area in terms of unemployment, employment trends, and income levels. Also, the age and condition of facilities and metrics such as capital expenditures to deprecation offer important insights to the competitive market. Of concern to Fitch, at times, is the capital spending "arms race" that occurs in some markets, especially in those states where no certificate of need is required.

3. Operational Effectiveness

This portion of rating agency assessment becomes more quantitative and tends to focus on volume trends, quality scores, and payer mix. The analysis becomes difficult when comparing state-to-state because some states expanded Medicaid while others did not.

Quality will become a larger component of overall assessment. This is especially true given that consumers will continue to become more aware and knowledgeable of quality outcomes at the providers in a specific service area. Hence, this will likely become a key differentiator in certain markets.

From a qualitative perspective, Fitch reviews staffing and nursing, and compares the coordination of incentives for physicians to the long-term strategy of the hospital or system.

4. Financial Profile/Sufficiency of Financial Resources

This component of the evaluation process focuses on profitability, liquidity, debt coverage metrics, etc. Over the past decade since the credit crisis, Mr. Pascaris reports that Fitch has become more sophisticated in evaluating investment strategies and the impact on liquidity. This is especially true for hospitals with aggressive debt structures that include a high proportion of variable or puttable debt. Fitch also factors into its ratio analysis "debt-like equivalents" such as pensions and operating leases.

Fitch's key financial metrics denoting stronger and weaker hospital financial condition include the table in Figure 1:

Figure 1:

	Stronger Metrics	Weaker Metrics
MADS Coverage	Above 4.0x	Less than 2.5x
MADS as % of revenue	Less than 2.5%	Above 3.5%
Cash on Hand	Above 200 days	Less than 125 days
Operating EBIDA margin	Above 10%	Below 8%

Source: *Fitch Ratings,* Rating Agency Update

Summary

For 2017, Fitch expects most of its individual ratings will be affirmations with a stable outlook and that upgrades and downgrades will be relatively equal. In part, this is due to improvement in managements' ability to react and respond to day-to-day challenges or threats in managing the bottom line. Plus, gaining improved tools for revenue cycle management, supply chain efficiencies, and tighter capital spending have helped in this area.

Regarding the sector, Fitch assigns a negative outlook. A key factor of this outlook is largely tied to the massive federal budget deficit and potential need for Medicare spending cuts if a balanced budget is ever to be achieved. Presently, Fitch indicates that Medicare spending accounts for approximately 25% of the federal budget. Other factors that contribute to the outlook include moderate commercial payor increases, drug and implant cost increases, labor wage pressures in certain markets, and the 800-pound gorilla – continued uncertainty around health care reform.

Highlights

- Increasing Consolidation:

Fitch expects the industry to continue to consolidate as hospitals seek to:

- achieve greater economies of scale,
- expand geographic footprints,
- enhance physician alignment strategies, and
- improve access to capital.

These objectives include traditional mergers as well as non-traditional alignments like partnerships and affiliations without a full asset merger or handing over control.

- Changing Operating Environment:

Mr. Pascaris indicates that the shift from fee-for-service to quality-based reimbursement has been slower than many expected. As such, the hospital operating environment has been challenged to find efficiencies but technology improvements have helped smooth this impact. The operating environment has been further challenged by increased Medicare and Medicaid volumes and the ability to maintain healthy margins has been difficult.

- Changing Reimbursement Structures:

While the U.S. healthcare system will continue to have the fee-for-service model for some time, CMS' (Centers for Medicare and Medicaid Services) objective is for 90% of Medicare payments to be derived from quality-based reimbursement by 2018. This is significant as approximately 45% of the revenue base of the average hospital is from Medicare reimbursements. Nonetheless, hospitals will be forced to operate in this "parallel universe" for a long time to come. A critical element in navigating this universe is information technology and the ability to harness and optimize data. A consumer-oriented focus on price transparency and understanding the dynamics of the local population, in what Mr. Pascaris termed the "uberization of healthcare", is also required to remain competitive.

- Summary of American Health Care Act of 2017:

Mr. Pascaris provided a brief summary of the revised AHCA from Fitch's initial perspective.

Figure 2:	Median	'AA Rated'	'A' Rated	'BBB' Rated
Days Cash on Hand	204 days	277 days	216 days	161 days
Operating Margin	3.5%	5.2%	3.8%	1.5%
Operating EBIDA Margin	10.3%	11.7%	10.3%	8.7%
MADS as % of Revenue	2.8%	2.2%	2.7%	3.6%
Deb to Capitalization	38.4%	28.4%	36.0%	50.2%

He offered the following:

- If passed, the CBO estimates that the AHCA would result in 23 million fewer people insured in 2026 than today.
- Even if the AHCA is not passed, the Trump administration can weaken the current law through the regulatory framework and tax code interpretation.
- While some provisions of the AHCA are positive for non-profit hospitals, overall the AHCA is a "material" credit negative for the sector due to significant growth in expected uncompensated care.

See Figure 2 for Fitch's Summary Median Statistics for 2016.

About Ellwood's Healthcare Practice

For nearly forty years, Ellwood has worked with stand-alone community hospitals, regional medical centers, and large healthcare systems. During that time, Ellwood has developed an expansive knowledge base, resources, investment expertise, and experience in an effort to enhance hospital/healthcare investment programs. Currently, Ellwood's consulting assets under advisement are in excess of $57 billion, of which approximately $10 billion represents hospital/healthcare clients. In addition, Ellwood is actively seeking to add new clients to our existing Hospital and Healthcare clientele.

If you or any of your peers at not-for-profit hospitals or healthcare systems are seeking investment consulting expertise, please contact Tim Egan at 312-782-5432 or Tim.Egan@ellwoodassociates.com. In addition, please visit Ellwood's website at www.ellwoodassociates.com. E

About Ellwood
For four decades, Ellwood has customized investment programs that are practical, grounded in fundamental research, and focused on bottom-line performance. Our consulting practice is national in scope and is focused on serving seven primary practice areas: Healthcare Systems and Hospitals, Corporate Defined Benefit Plans, Corporate Defined Contribution Plans, Endowments and Foundations, Public Funds, High-Net-Worth Clients, and Wealth Management Advisory Services.

Ellwood was founded in 1977 and is a 100% employee-owned, independent investment consulting firm with no parent or affiliate organizations. Ellwood is based in Chicago, IL with a regional office in the Denver, CO area.

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