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U.S. Not-For-Profit Small Hospitals Move Toward Stability

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*(**Editor's Note:** As of 2008, we have been using a new naming convention for our median ratio reports. This year's set of medians are referred to as the 2009 medians, which is intended to reflect the time period of the data used for the calculation of specific ratios. In this case, the 2009 medians are derived from fiscal 2009 audited financial statements.)*

Operating and balance sheet metrics for U.S. not-for-profit small hospitals showed signs of improvement in fiscal 2009, according to Standard & Poor's Ratings Services' analysis of key median ratios. Based on our tracking of small hospital metrics, we see that the broader global economic turmoil that began in late 2007 and caused some distress for small hospitals' operations into 2008 began to lift in 2009. We believe that the sector's response to the recession, which focused on tightening expenses and strengthening service lines, have helped small hospitals improve operating margins. This improvement is consistent with our 2010 outlook for the entire health care sector (see "U.S. Not-For-Profit Health Care Sector Moves Toward Stability, But Its Long-term Outlook is Uncertain," published Feb. 18, 2010, on RatingsDirect on the Global Credit Portal).

We reviewed ratios for small hospitals rated by Standard & Poor's with annual net patient revenues of less than $100 million. The number of rated small hospitals decreased to 71 in 2009, from 83 in 2008 primarily because seven hospitals no longer qualified as small hospitals. We found that the smaller sample size in 2009 resulted in certain hospitals overly influencing the medians, causing mixed results in some rating levels, especially in the 'A' rating category.

Compared with the larger stand-alone hospitals, small hospitals are more likely to be located in rural communities that have narrow economic bases and small medical staffs, which we view as added risks. Small hospitals fall predominantly in the 'BBB' rating category and constitute 60% of the hospitals included in this report (see table 1). The remaining hospitals are split almost evenly between the 'A' rating category and speculative-grade rating category ('BB+' and below).

We have found that small hospitals typically have stronger balance sheets and perform better than their stand-alone counterparts at comparable rating levels, which we believe compensates for some of the additional risks. In 2009, despite softer volumes and weaker nonoperating income, most of the small-hospital medians continued to exceed the medians of larger stand-alone hospitals.

Table 1

Small Hospital Median Ratios 2009

	'A' to 'A-'		'BBB+'		'BBB'		'BBB-'		Speculative grade	
	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008
Sample size	15	19	6	8	10	16	26	25	14	15
Statement of operations										
Net patient revenue (NPR; $000)	73,537.00	75,729.00	83,097.50	81,126.00	69,799.50	69,257.50	63,705.50	58,732.00	60,782.50	59,470.00
Salaries and benefits/NPR (%)	54.8	54.0	50.8	54.2	47.5	48.3	50.3	50.7	47.0	47.5

Table 1

Small Hospital Median Ratios 2009 (cont.)										
Bad debts expense/total operating revenue (%)	5.1	5.5	5.6	4.3	5.3	6.1	6.6	7.0	7.3	5.3
Maximum debt service coverage (x)	3.0	4.1	2.0	3.9	3.1	2.9	2.3	2.3	2.0	1.8
Maximum debt service/total operating revenue (%)	3.4	3.4	4.8	4.2	4.2	4.0	4.6	4.9	3.4	3.6
Max debt service/total revenue (%) (Debt burden)	3.3	3.2	5.1	4.1	4.2	4.0	4.7	4.9	3.4	3.5
EBIDA ($000)	7,509.00	9,207.00	8,497.00	9,124.50	6,491.50	6,478.50	7,493.00	7,078.50	5,292.50	4,600.00
Nonoperating revenue (%)	1.5	2.9	(2.2)	3.1	0.9	1.6	1.2	1.9	0.5	1.4
EBIDA margin (%)	11.3	14.3	11.3	13.0	11.8	9.4	10.2	10.6	7.3	5.6
Operating cash flow margin (%)	11.7	10.9	12.1	9.8	11.8	9.5	9.7	8.8	7.0	5.7
Operating margin (%)	2.1	2.5	3.2	0.3	3.3	1.6	1.1	0.6	(0.6)	(1.7)
Excess margin (%)	3.0	6.9	2.9	4.4	4.0	2.6	2.3	2.8	(0.2)	(0.2)
Capital expense/depreciation and amortization expense	180.8	178.2	76.0	123.2	140.0	140.5	86.3	103.8	75.2	72.3
Balance sheet										
Average age of plant (years)	11.1	10.2	8.1	8.5	7.8	8.5	8.8	10.3	10.8	11.7
Cushion ratio (x)	20.2	18.9	13.7	12.8	12.0	10.3	7.8	7.3	5.3	5.2
Days' cash on hand	275	323	222	179	176	127	145	123	67	74
Days in accounts receivable	50.0	58.3	45.4	56.1	40.3	46.5	48.5	57.2	44.2	42.3
Cash flow/total liabilities (%)	18.6	23.4	13.6	22.7	17.2	13.1	13.8	13.5	8.5	7.1
Unrestricted cash/long-term debt (%)	246.9	222.4	130.1	118.6	115.2	94.7	79.8	76.7	56.8	55.2
Long-term debt/capitalization (%)	21.7	22.8	30.8	30.2	37.7	40.7	40.3	42.3	45.0	45.2
Payment period (days)	56.7	56.5	61.9	68.2	50.3	53.4	46.7	50.9	64.9	65.3

Median Ratios Show Improvement In 2009 After Decline In 2008

In 2008 and 2009, patient volumes decreased in the overall hospital market. In our view, these volume shifts affected small hospitals more than larger hospitals because small hospitals have fewer physicians and a limited service mix. Many small hospitals have weathered the recent economic challenges by focusing on physician recruitment to minimize decreased volumes and by implementing cost controls to improve operations. In addition, unemployment rates have tended to be higher in recent years in the rural areas where most of the small hospitals are located, resulting in increased levels of uninsured patients, which we believe contributed to increased bad-debt expenses and charity care. After declines in small-hospital operating margins for most of the rating categories in 2008, we saw operations improve in 2009, although they did not quite bounce back to the levels seen in 2007 and 2006 (see table 3).

Our analysis shows that excess income also suffered in 2008 in all rating categories due to weaker investment

market returns. In 2009, the excess income median ratio continued to decline in most of the categories except the 'BBB' rating category. Compared with larger stand-alone hospitals, small hospitals tend to have what we consider to be more conservative investment portfolios with a higher allocation in fixed-income securities. Because the fixed-income market is recovering at a slower pace than the equities market, we have not seen small hospitals' excess income improve in the latter part of 2009 as we saw for larger stand-alone hospitals with more diverse investment portfolios. The few small hospitals with less conservative portfolios are primarily in the 'A' rating category and a few years ago experienced greater investment losses. Because most of these hospitals have fiscal years ending in July or earlier, median nonoperating revenue as a percentage of total revenues and the median excess-income ratio for 2009 are down from 2008. Of the small hospitals in this report, 40% have fiscal years ending in July or earlier and, therefore, the median ratios do not reflect any recent improvements in nonoperating income. However, with the recent improvement in investment markets, we saw cash levels increase from positive unrealized gains in addition to limited capital spending (see table 3).

The balance sheet median ratios for small hospitals have improved overall from the increase in unrestricted cash and investment gains but exhibit some mixed results in the higher and lower rating categories. Liquidity has significantly increased across the 'BBB' rating category and in most cases has increased beyond 2006 and 2007 levels. We believe liquidity for small hospitals has improved partly due to reduced capital spending, as demonstrated by a lower median capital expense to depreciation ratio. Access to capital was more limited for all providers in 2008 and 2009 compared with 2006 and 2007, especially for small hospitals. The limited additional debt issuance resulted in leverage levels remaining relatively stable and an increase in unrestricted cash to long-term debt in 2009 after a decline in 2008.

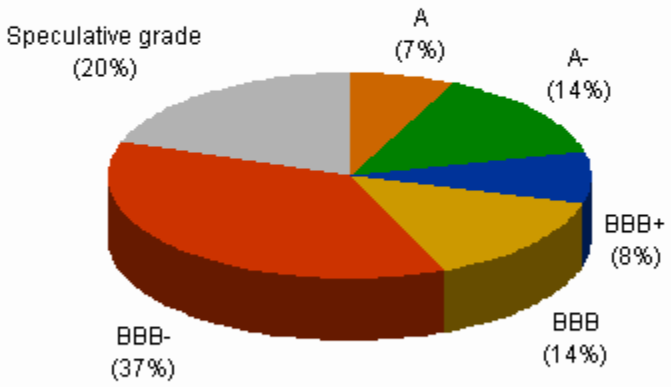
Rating Changes Demonstrate Stability In 2009

Although the economic downturn, which continued into 2009, generally hurt small hospitals, ratings remained relatively stable. Since August 2009, we affirmed 86% of all small hospital ratings. Of those hospitals reviewed, we revised 18 outlooks, with an equal number changing in positive and negative directions. While downgrades exceeded upgrades by five to zero, this was an improvement over the previous comparable period when downgrades exceeded upgrades nine to zero. In addition, during the previous year, there were eight unfavorable outlook changes and only two favorable outlook changes. Taken together, we believe our ratings on small hospitals exhibited greater stability in the 2009 review period.

While rating changes for small hospitals are stabilizing, the pace has been slower than that of stand-alone hospitals. Stand-alone hospitals experienced a positive shift in rating and outlook changes during the first quarter of 2010 (see "U.S. Not-For-Profit Stand-Alone Hospital Sector Performance Shows Gradual Improvement," published July 19, 2010). In addition, seven hospitals that were all higher-rated hospitals (with 'A' and 'BBB+' ratings) in 2009 no longer qualified as small hospitals in 2010. The change, we believe, has weakened the rating distribution of small hospitals (see charts 1 and 2).

Chart 1

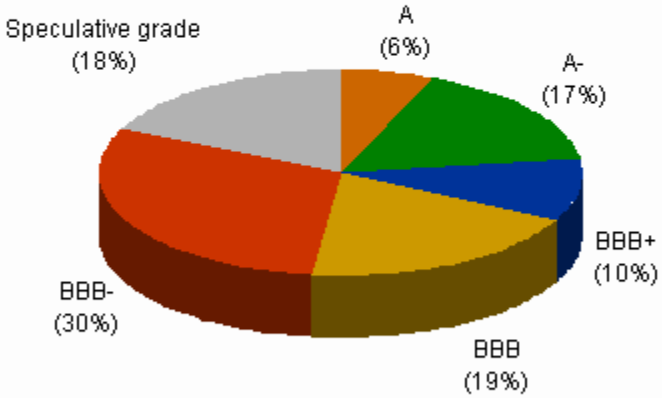
Small Hospital Rating Distribution 2009



Between June 30, 2010, and Aug. 31, 2010, the rating on one hospital was raised and ratings on five hospitals were affirmed with one outlook revised to positive. Ratings are of June 30, 2010.

Chart 2

Small Hospital Ratings Distribution 2008



Ratings are as of June 30, 2009.

The Longer-Term Outlook Is Tied To Health Care Reform

We expect the small hospital sector to remain relatively stable for the next two to three years due to improved operations and lower capital spending. Although operations have not returned to 2006 and 2007 levels, we believe that most small hospitals will likely be able to manage ongoing economic pressures. However, we are uncertain if operating margins will continue to grow or remain stable at current levels as small hospitals look for opportunities to increase volumes and cut costs amid continued soft patient volumes and higher unemployment.

We believe the longer-term outlook for small hospitals, like all hospitals, is also uncertain as they cope with the unfolding impact of the health care reform law, in addition to the ongoing economic pressures (see "Health Care Reform Could Increase Credit Risk For U.S. Not-For-Profit Providers," published May 13, 2010). While we believe the law has several favorable provisions for small and rural hospitals and will likely increase the number of insured patients, we also believe small hospitals will experience elevated costs from implementing electronic health records and reporting quality data as well as possible lower payments from Medicare and Medicaid. One new pilot program aims to provide cost reimbursement, similar to critical access hospitals, for 20 providers that are a bit too large to qualify for critical access status. While this will be helpful for this small group of hospitals, it does reflect considerable support for rural hospitals in Congress. We will continue to monitor the changes resulting from the law's implementation and its financial impact on the small hospital sector.

The Median Rating For Small Hospitals Is In The 'BBB' Category

Consistent with historical trends, we see that smaller hospitals typically demonstrate stronger operating performance and cash flow as well as more robust balance sheet measures than their similarly rated stand-alone counterparts (see table 3). Small hospitals show more robust credit metrics at each rating level, which we believe offsets the susceptibility to volume shifts, smaller medical staffs, and limited population pools. In addition, small hospitals tend to have a payor mix with a high concentration of Medicare and Medicaid and few commercial payors (for more details, see "Sidebar: Small Hospitals Have Unique Characteristics", below).

The relative financial strength of small hospitals versus stand-alone hospitals is evident across virtually all rating categories, except in the speculative-grade rating range. There is a much greater percentage of higher-rated ('A-' rating or above) providers in Standard & Poor's stand-alone hospital sector than in its small hospital pool. Conversely, there's a greater percentage of providers with speculative-grade ratings in the small hospital pool than in the stand-alone segment. Overall, the small hospital pool's median rating is 'BBB-', which is commensurate with the median rating reported in previous years and not unusual given the greater credit risk associated with this aggregation of providers (see sidebar). Comparatively, the stand-alone pool's median rating falls in the 'A-' rating category (see table 2).

Table 2

Small And Stand-Alone Hospital Medians 2008

	'A' to 'A-'		'BBB+'		'BBB'		'BBB-'		Speculative grade	
	Small	Stand-alone	Small	Stand-alone	Small	Stand-alone	Small	Stand-alone	Small	Stand-alone
Sample size	15	182	6	60	10	57	26	49	14	38

Table 2

Small And Stand-Alone Hospital Medians 2008 (cont.)

Statement of operations										
Net patient revenue (NPR; $000)	73,537.00	248,238.00	83,097.50	250,133.00	69,799.50	176,968.00	63,705.50	97,580.00	60,782.50	124,697.00
Salaries and benefits/NPR (%)	54.8	50.9	50.8	54.2	47.5	49.0	50.3	51.0	47.0	51.5
Bad debts expense/total operating revenue (%)	5.1	6.6	5.6	5.5	5.3	5.7	6.6	6.7	7.3	7.2
Maximum debt service coverage (x)	3.0	3.2	2.0	2.4	3.1	3.0	2.3	2.3	2.0	2.0
Maximum debt service/total operating revenue (%)	3.4	3.3	4.8	3.2	4.2	3.4	4.6	3.9	3.4	3.4
Max debt service/total revenue (%) (Debt burden)	3.3	3.2	5.1	3.2	4.2	3.4	4.7	3.8	3.4	3.2
EBIDA ($000)	7,509.00	22,223.00	8,497.00	22,013.00	6,491.50	19,830.00	7,493.00	10,319.00	5,292.50	8,938.00
Nonoperating revenue (%)	1.5	0.8	(2.2)	0.5	0.9	0.6	1.2	0.9	0.5	0.4
EBIDA margin (%)	11.3	9.9	11.3	8.3	11.8	9.5	10.2	9.5	7.3	6.6
Operating cash flow margin (%)	11.7	9.9	12.1	8.1	11.8	9.3	9.7	8.6	7.0	5.6
Operating margin (%)	2.1	2.1	3.2	1.6	3.3	2.3	1.1	0.6	(0.6)	(0.7)
Excess margin (%)	3.0	3.0	2.9	1.6	4.0	2.3	2.3	1.6	(0.2)	(0.2)
Capital expense/depreciation and amortization expense	180.8	156.9	76.0	108.6	140.0	112.6	86.3	95.3	75.2	83.6
Balance sheet										
Average age of plant (years)	11.1	10.1	8.1	10.0	7.8	10.3	8.8	9.8	10.8	12.1
Cushion ratio (x)	20.2	13.8	13.7	10.0	12.0	9.5	7.8	7.6	5.3	5.2
Days' cash on hand	275	176.3	222	125.7	176	125.1	145	107.9	67	66.1
Days in accounts receivable	50.0	47.4	45.4	45.5	40.3	45.1	48.5	48.5	44.2	45.1
Cash flow/total liabilities (%)	18.6	15.8	13.6	12.2	17.2	14.6	13.8	10.9	8.5	7.7
Unrestricted cash/long-term debt (%)	246.9	117.4	130.1	99.3	115.2	88.2	79.8	66.0	56.8	57.8
Long-term debt/capitalization (%)	21.7	36.6	30.8	40.1	37.7	43.1	40.3	43.2	45.0	51.3
Payment period (days)	56.7	51.7	61.9	53.2	50.3	52.7	46.7	53.8	64.9	61.9

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Sidebar: Small Hospitals Have Unique Characteristics

While small hospitals share some of the trends and characteristics of the larger hospital universe, we believe they have a number of relatively unique business characteristics, including:

- Reliance on a small complement of active physicians for the bulk of business volumes, which in our view highlights the need for strong medical staff recruiting and retention. However, this is often very difficult for small hospitals, although there are exceptions in a few cities that are tourist destinations;
- Location in rural and outlying areas with limited population and economic diversification, which we believe leaves many small providers vulnerable to the success of a narrow group of employers or a single industry;
- Competition from larger providers with a more comprehensive range of services that can draw more profitable business away from a given service area, although in our view, this is generally dependent on the distance to the more comprehensive provider; and
- A payor mix that has a large percentage of governmental payor (Medicare and Medicaid) patients, typically tempered by a commercial payor mix that often has adequate contract terms but can be concentrated among one or two payors.

In general, we believe these business characteristics present a higher risk profile than the larger universe of health care ratings, and as a result, small hospital ratings tend to fall predominantly in the 'BBB' rating category. In addition, we believe there is potential for significant fluctuation in the pool's overall business volumes. We believe these fluctuations can be more severe than in larger hospitals because the business base is smaller and slight changes can cause greater disruption in financial performance. From a ratings perspective, because of this potential volatility, we generally expect smaller hospitals to have stronger credit characteristics than their larger stand-alone counterparts.

While there are more risks associated with small hospitals in our opinion, we believe these hospitals also continue to benefit from some common strengths including:

- Limited competition and frequent designation as sole community providers, which can qualify a hospital for special formulas that result in higher payments, or cost reimbursement without the cost limits normally used for the applicable provider type. Thus, sole community providers receive higher payments and reimbursement than other rural providers;
- Low cost structure, but salaries and wages can be higher depending on location and physician specialty, where recruitment is more difficult;
- Conservative investment portfolios, which hedge against financial and operational volatility; and
- Limited noncore business activities, such as insurance or managed-care operations that can drain resources.

In addition, small hospitals occasionally use outside companies to help manage their operations. While we do not see the use of outside management companies as a trend across this segment, we believe these third parties can provide benefits that might not normally be available to small hospitals. Specifically, management companies can provide access to group purchasing, benchmarking data, information technology, and consulting services, which are often not available to small hospitals with more limited resources.

Table 3

Rated Small Hospitals

	State	Rating
Alliance Citizens Health Assn. and Subsidiaries	OH	BBB-
Arkansas Methodist Medical Center	AR	BBB-
Avera Holy Family Health	SD	A
Bates County Memorial Hospital	MO	BBB-
Bloomsburg Health System and Controlled Entities	PA	CCC
Brazosport Regional Health System	TX	BBB-
Brooks Health System	FL	A
Casa Colina Centers for Rehabilitation	CA	BBB+
Central Michigan Community Hospital and Subsidiaries	MI	BBB-
Chattahoochee Valley Hospital Society	AL	BB-
Chippewa County War Memorial Hospital Inc.	MI	BB
Clarion Hospital	PA	BBB-
Community Hospital of Ottawa	IL	A-
CRH Health Care Inc. (Coffee Regional Medical Center)	GA	BBB-
Delano Regional Medical Center	CA	BBB-
Delta County Memorial Hospital District	CO	BBB
Divine Savior Healthcare Inc.	WI	BBB
Duncan Regional Hospital Inc.	OK	A
East Liverpool City Hospital Inc.	OH	A-
Gerald Champion Regional Medical Center	NM	BBB+
Gila Regional Medical Center	NM	BBB
Good Shepherd Group	PA	A
Great Plains Regional Medical Center	OK	BBB-
Gritman Medical Center	ID	BBB
Halifax Regional Hospital	VA	A-
Hillsdale Community Health Center	MI	BB+
Hopkins County Hospital District	TX	BBB-
Howard Young Health Care Inc. and Affiliates	WI	BBB
Huron Regional Medical Center Inc.	SD	A-
Jackson County Memorial Hospital Authority	OK	BB
Lake Region Healthcare Corp.	MN	A-
Lewistown Hospital	PA	BBB-
Orthopaedic Hospital and Los Angeles Orthopaedic Foundation	CA	BBB+
Madison Memorial Hospital	ID	BBB-
Maria Parham Medical Center	NC	BB
Mary Lanning Memorial Hospital Assn. and Affiliates	NE	A-
Mary Rutan Hospital	OH	A-
Memorial Healthcare Center of Owosso and Subsidiaries	MI	BBB
Milton Hospital	MA	BB-
Montrose Memorial Hospital	CO	BBB-
National Jewish Health	CO	BBB-

Table 3

Rated Small Hospitals (cont.)		
Nevada Regional Medical Center	MO	BBB-
Nicholas H. Noyes Memorial Hospital's parent (Livingston Health Care System Inc.)	NY	BB
North Country Health Services	MN	BBB+
Northern Hospital District of Surry County	NC	BBB
Northern Inyo County Local Hospital District	CA	BBB-
Northfield City Hospital	MN	BBB-
Oak Valley Hospital District	CA	BBB-
Oaklawn Hospital	MI	BBB-
Oconee Regional Medical Center	GA	BB+
Oneida Healthcare System	NY	BBB-
Prairie Lakes Health Care System	SD	A
Regina Medical Center	MN	BB+
Riverview Hospital Assn.	WI	A-
Rockcastle Hospital and Respiratory Care Center Inc. and Subsidiaries	KY	BBB-
Russell Hospital Corp.	AL	BB+
Ryder Memorial Hospital	PR	BB
Sid Peterson Memorial Hospital	TX	BBB-
Somerset Community Hospital	PA	BBB
Stillwater Medical Center	OK	BBB+
Susan B. Allen Memorial Hospital System	KS	BBB-
Tahoe Forest Hospital District	CA	BBB-
Thorek Memorial Hospital	IL	A-
Unity Health Center (Shawnee Regional)	OK	A-
Upland Hills Health Inc. (formerly known as Memorial Hospital of Iowa County)	WI	BBB
Vernon Memorial Hospital	WI	BBB-
Watertown Regional Medical Center Inc.	WI	BBB+
West Branch Regional Medical Center's parent (John Tolfree Health System Corp. and Subsidiaries)	MI	BB
Westerly Hospital and Subsidiaries	RI	BB-
Winona Health Services Inc.	MN	BBB-
Yampa Valley Medical Center	CO	BBB

Table 4

Glossary	
Adjusted cash flow	Net cash from operating activities - working capital change
Averageage of plant	Accumulated depreciation/depreciation expense
Bad debt expense/total Operating revenue	(Bad debt expense/(net patient revenue + other operating revenue)) X 100
Cash	Unrestricted cash and investments + unrestricted board designated funds
Cashflow/total liabilities	((Net income + depreciation and amortization expenses)/total liabilities) X 100
Cushion ratio	Cash/maximum annual debt service
Days' cash on hand	Cash/((operating expense – depreciation expense)/365)
Days' in accounts receivable	(Net accounts receivable X 365)/net patient revenue
EBIDA	Net income + interest, depreciation, and amortization expenses
EBIDA margin	(EBIDA/total revenue) X 100

Table 4

Glossary (cont.)	
Interest coverage	Net available for debt service/interest expense
Long-term debt/capitalization	(Long term debt/(unrestricted net assets + long term debt)) X 100
Maximum debt service/total operating revenue	(Maximum annual debt service/ (net patient revenue + other operating revenue)) X 100
Maximum debt service/total revenue	(Maximum annual debt service/ total revenue) X 100
Maximum debt service coverage	Net available for debt service/maximum annual debt service
Net available for debt service	Net income + depreciation and amortization expenses + interest expense
Net income	Operating Income + net non-operating revenue
Net patient revenue	Gross patient revenue – contractual allowances
Nonoperating revenue	Investment earnings, contributions, and other nonoperating revenue (excludes unrealized gains or losses on investments)
Nonoperating revenue/total revenue	(Non operating revenue/total revenue) X 100
Operating income	Total operating revenue - total operating expenses
Operating margin	(Operating income/total operating revenue) X 100
Operating cash flow margin	(Adjusted cash flow/total opreating revenue) x 100
Capital expenditures/depreciation and amortization	(Purchases of property plant and equipment/depreciation and amortization expense) X 100
Payment period	(Current liabilities/(total expense – depreciation and amortization expenses)) X 365
Excess margin	(Net income/total revenue) X 100
Salaries and benefits/net patient revenue	((Salary expense + benefit expense)/net patient revenue) X 100
Total revenue	Net patient revenue + other operating revenue + non-operating revenue
Unrestricted cash/long-term Debt	(Cash/long-term debt) X 100