Rating Methodology: Hospital Industry

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Background

Hospitals, the largest segment of the healthcare services industry in India, have evolved from being primary health centres to single and multi-speciality corporate over the years. The sector comprises pharmacies, diagnostics, medical equipment and supplies, medical insurance, and telemedicine segments among others. Today, hospitals can be classified under three broad segments:

Primary Care: The first point of contact between the populace and the healthcare service providers offers basic medical and health prevention services and is further divided into Sub Centre (SC), Primary Health Centre (PHC), and Community Health Centre (CHC), which is more relevant to rural areas.

Secondary Care: This category provides inpatient, as well as outpatient medical services and includes simple surgical procedures. Medical specialities such as internal medicine, paediatrics and a limited part of urology, cardiology etc come are covered under this. Patients to these hospitals are mainly referred by health professionals from primary-level hospitals for specialised treatment.

Tertiary Care: The third level of the healthcare delivery system includes specialised consultative healthcare infrastructures that see referrals from primary and secondary health professionals. While there are tertiary hospitals that offer services for a single speciality, there are multi-speciality tertiary hospitals that provide several services in the same hospital.

Rating Methodology

CARE Ratings has a well-laid-out methodology for the rating of entities belonging to the healthcare service sector. CARE Ratings' rating process begins with the evaluation of the economy/industry in which the entity operates, as well as the assessment of the business risk factors specific to the entity. This is followed by an evaluation of the financial and project-related risk factors as well as the quality of the management. This methodology is adopted while analysing all entities that come under the purview of the service sector. However, considering the size and diversity of each sector, CARE Ratings has developed methodologies specific to various sectors. These methodologies attempt to point out factors, over and above those mentioned in the broad methodology, which will be assessed while determining the rating of entities belonging to the particular industry. The following is a list of such additional factors, along with their analytical implications, considered by CARE Ratings while arriving at the rating of the players that operate in the hospital sector.

Business Risk

Brand and Competitive Position

CARE Ratings evaluates the brand image and competitive position of a hospital as it has a considerable bearing on its ability to attract a larger number of patients and renowned doctors. A better brand image and competitive position not only ensures a higher market share but also leads to better profitability. While evaluating the competitive position of the hospital, CARE Ratings evaluates factors such as track record of the hospital, specialties being provided, accreditations, presence of renowned doctors, and the number of patients. In CARE Ratings' view, hospitals with multi-specialty are better placed as compared to a single specialty in terms of pricing power. Similarly, hospitals with renowned accreditations such as the National Accreditation Board for Hospitals & Healthcare Providers (NABH) and Joint Commission International (JCI) do command a better competitive position.

Scale and Diversification

While assigning the rating, CARE Ratings considers the scale of business operations in terms of bed inventory and revenue diversification as important rating considerations as these provide revenue stability and lead to economies of scale in business operations, marketing, and distribution.

With respect to revenue diversification, CARE Ratings analyses geographical diversification, specialty-wise diversification, and international to domestic patients' break-up. Under the geographical diversification, CARE Ratings evaluates the entity's presence in the number of cities in India and overseas and its plans to increase its coverage. Hospital entities have been increasing their geographical coverage by venturing into Tier-II and Tier-III cities and also through overseas satellite facilities.

A healthy mix of specialty-wise diversification is important for hospital entities, while some specialties such as cardiology and neurology are high-margin contributors whereas others such as gynaecology, paediatrics, and radiology contribute most to the occupancy. CARE Ratings also evaluates the revenue mix of a hospital in terms of domestic and international patients. A higher percentage contribution from international patients gives higher profitability for hospitals. In the case of hospital chains, higher investments in new geographies may pose challenge in terms of achieving operational stability in a timely manner. CARE Ratings looks at the mix of revenue from matured and recently established hospitals as matured hospitals tend to provide better profitability with stable revenue.

Location Analysis

CARE Ratings analyses the location of the hospital as it is an important factor to determine the hospital's ability to attract patients and impact the occupancy and thereby its cash flows. Hospitals located in metro cities will have higher Average Revenue per Occupied Bed (ARPOB) as compared to hospitals located in non-metro cities. Apart from this, CARE Ratings also looks at the nearby hospitals and the services offered by them to do a competitive mapping.

Quality of Cash Flow

Hospitals receive payments in various forms and channels such as Cash business, Third-Party Agencies (TPA), Institutional clients, and Central Government Health Scheme (CGHS). CARE Ratings evaluates the percentage of revenue from each of the channels to ascertain the health of its cash flows. A healthy mix of patients from each of the channels is critical in maintaining optimum occupancy levels for the hospitals. In CARE Ratings' view, a hospital with more cash business will have better cash flow as compared to more of CGHS/TPA business wherein the payments are realized with delay. At the same time, higher CGHS/TPA business may help hospitals with higher occupancy.

Operating Performance

CARE Ratings analyses performance indicators of hospitals such as ARPOB, Average Length of Stay (ALOS), and occupancy ratio to ascertain the operational efficiency of the issuer.

ARPOB refers to the average revenue realised by a hospital from every occupied bed and depends on the pricing of hospitals, location of hospitals (Tier-I or Tier-II city), utilisation rates of beds, maturity of hospitals, and complexity of operations conducted in hospitals. CARE Ratings evaluates movement in ARPOB in the past vis-à-vis its peers and the ability of a hospital to charge ARPOB at a premium over industry ARPOB without compromising on occupancy levels.

CARE Ratings also evaluates ALOS of a hospital that refers to the average time spent by the patient under treatment in the hospital. In CARE Ratings' view, lower ALOS helps in faster turnaround of beds and results in more patients being treated from the current facilities. In addition to this, it also helps the hospitals to increase their income as most of the revenues are made by hospitals in the initial few days of the patient's treatment.

Adequacy and Quality of Medical Team

In CARE Ratings' view, doctors and medical staffs are a critical resource for hospitals. The presence of renowned and skilled doctors tends to attract a higher number of patients and can help hospitals to charge a premium for the services. CARE Ratings analyses the quality and adequacy of the medical team of hospital entities. It evaluates the "Doctor per bed" ratio to ascertain the adequacy of doctors, too. An optimum level of "doctor per bed" is needed as a low ratio can act as an impediment to the service levels, and a high ratio might lead to pressure on the margins.

A Doctor's fee is one of the largest components in the hospital's cost structure and CARE Ratings analyses various remuneration models to ascertain its impact on the profitability. While a higher number of payroll doctors leads to higher cost, it also leads to a better brand on the other hand higher visiting doctors may be cost effective but might dilute the brand. In CARE Ratings' view, a judicious mix of payroll and visiting doctors are needed to maintain the balance between the quality and cost of services.

Promoters/Management Analysis

Experience and market image of the promoters are given utmost importance while evaluating management competency and quality. CARE Ratings assesses management's ability to run the business efficiently while addressing the inherent business risk associated with hospital operations and undertaking judicious expansion activities. Many of the hospitals are promoted by doctors without adequate professional set-up. In such cases, keyman risk and succession planning are also taken into consideration.

The hospital business is capital-intensive and has a long gestation period; therefore, an entity with financially strong promoters enjoys an advantage over others as its ability to infuse and/or raise funds promptly is crucial. Furthermore, the strong group presence/parentage provides enhanced financial flexibility. The rating methodology for hospital entities also lays considerable stress on the commitment of the promoters not only in the form of equity but also their ability to continuously support during the initial years of operations for loss funding and debt servicing if needed and their active involvement in the operations of the entity, considering the importance of the entity in the overall group's portfolio.

Financial Risk

CARE Ratings follows its standard ratio analysis methodology for manufacturing entities to assess the financial risk of entities in the hospital sector (refer to CARE Ratings' Rating Methodology for non-financial sector on our website www.careedge.in).

Project Risk

While examining new/expansion plans, CARE Ratings evaluates the rationale of the project, its strategic importance in the entity's business plan, the kind of services being offered such as the presence of treatment for critical diseases and the magnitude of the project vis-à-vis the net worth/asset size of the entity. CARE Ratings also evaluates the location demand-supply situation at the time of the project completion and analyses its impact on the entity's financials and future cash flows. While examining an ongoing project, CARE Ratings examines the stage of approvals, licenses, governmental clearance, and the possibility of time and cost overrun.

CARE Ratings also considers the management's past track record of executing projects with a judicious mix of debt and equity components and without any cost/time overruns as a critical success factor. The facilities being offered, the competitive positioning, relative cost structure, cost per bed, funding sources, debt structure of the project, and accessibility of various sources of funding are assessed. Due to the long gestation period, the timing of setting up or expansion is of critical importance for any entity.

With respect to the funding risk of the project, CARE Ratings also analyses the source of funding and its consequent impact on the capital structure on the entity.

Regulatory Risk

Hospitals operate in a regulated industry that has witnessed continuous regulatory intervention during the past couple of years in the country. In India, hospitals are governed by various laws such as the Indian Medical Council Act 1956, The Clinical Establishments (registration and regulation) Act 2010, the Indian Medical Council Regulations 2002, etc. Given the importance of healthcare facilities, the Indian Government has been taking various steps towards increasing the affordability and coverage of healthcare services in the country by putting price restrictions on pharmaceutical entities, medical equipment manufacturers, and hospital services. CARE Ratings views regulatory risk to be critical for hospital operations and continuously monitors its impact on operations, business continuity, profitability, and eventual credit profile.

Conclusion

The rating outcome is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. CARE Ratings analyses each of the above factors and their linkages to arrive at the overall assessment of the credit quality of the issuer. While the methodology encompasses comprehensive financial, commercial, economic, and management analyses, credit rating is an overall assessment of all aspects of the issuer.

[For the previous version please refer to 'Rating Methodology – Hospital Industry' issued in August 2020]

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