Rating Methodology – Hospital Industry

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Industry overview

Hospitals form a critical part of the overall healthcare industry. Apart from hospitals, the healthcare services industry comprises pharmaceutical, diagnostics, medical equipment and supplies, medical insurance, and telemedicine. The hospital industry is the largest segment of the healthcare services in the country which has proliferated from primary healthcare centres to single and multi-speciality corporate hospitals over the years. The hospital delivery system in India is primarily classified under three broad segments: Primary care, Secondary care, and Tertiary care.

Primary care is the first point of contact between the populace and the healthcare service providers. This infrastructure 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** provides inpatient as well as outpatient medical services and includes simple surgical procedures. It offers medical specialities including internal medicine, paediatrics and provides limited coverage of other specialities that includes urology, cardiology among others. Patients to these hospitals are mainly referred by health professionals from primary level hospitals for specialised treatment. **Tertiary care** is the third level of the healthcare delivery system in the country. These hospitals are specialised consultative healthcare infrastructures that have referrals from primary and secondary health professionals. While there are tertiary hospitals that offer services for single speciality, there are multi-speciality tertiary hospitals that offer several services in the same hospital.

Rating Methodology

CARE Ratings has a well laid-out methodology for the rating of entities belonging to the service sector. CARE's 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 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.

Promoters/Management Analysis

Experience and market image of the promoters are given utmost importance while evaluating management competency and quality. CARE assesses management's ability to run the business efficiently while addressing the inherent business risk associated with hospital operations and undertake judicious expansion activities. Hospital business is capital-intensive and has 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.

Business risk analysis

Brand and competitive position

CARE 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 evaluates factors such as track record of the hospital, specialties being provided, accreditations, presence of renowned doctors, and the number of patients. In CARE's 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 since they provide revenue stability and lead to economies of scale in business operations, marketing, and distribution.

With respect to revenue diversification, CARE analyzes the geographical diversification, specialty-wise diversification, international to domestic patients' break-up. Under the geographical diversification, CARE 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 in Tier II and Tier III cities in countries and also through overseas satellite facilities.

A healthy mix of specialty-wise diversification is important for hospital entities, as while some specialties such as cardiology and neurology are high-margin contributors whereas others such as gynecology, pediatric, and radiology contribute most to the occupancy. CARE 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, CARE also 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 analyses the location of the hospital as it is an important factor to determine hospital's ability to attract patients and impact the occupancy of the hospital and thereby influencing 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 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) scheme.

CARE 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's 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.

Operating performance

CARE 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 realized by a hospital from every occupied bed. ARPOB depends on the pricing of hospitals, location of hospitals (Tier I city, Tier II city), utilization rates of bed, maturity of hospitals, and complexity of operations conducted in hospitals. CARE 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 also evaluates ALOS of a hospital which refers to the average time spent by the patient under treatment in the hospital. In CARE's view, lower ALOS helps in faster turnaround of beds which 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 patients' treatment.

Adequacy and quality of the medical team

In CARE's view, doctors and medical staffs are a critical resource for hospitals. The presence of renowned doctors who are skilled and have earned a reputation in the market over the years tend to attract a higher number of patients and can help hospitals to charge a premium for the services provided by them. CARE analyses the quality and adequacy of the medical team of hospital entities. CARE evaluates the "Doctor per bed" ratio to ascertain the adequacy of doctors. An optimum level of "Doctor per bed" is needed as a low ratio can act as an impediment for the service levels, a high ratio might lead to pressure on the margins.

Doctor's fee is one of the largest components in the hospital's cost structure and CARE 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's view, a judicious mix of payroll and visiting doctors is needed to maintain the balance between the quality and cost of services.

Financial risk analysis

CARE follows its standard ratio analysis methodology for manufacturing entities to assess the financial risk of entities in the hospital sector (*refer to CARE's Rating Methodology for non-financial sector on our website [www.careratings.com)](http://www.careratings.com)* .

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 like 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 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 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 views regulatory risk to be critical for hospital operations and continuously monitors its impact on the operations, business continuity, impact on 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 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.

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