Rating Methodology – Hospital Industry

(Issued in July 2019)

Industry overview

The healthcare services industry comprises six segments: hospitals, pharmaceutical, diagnostics, medical equipment manufacturers and suppliers, medical insurance and telemedicine. Hospitals form a critical part of the overall healthcare industry. This is the largest segment of the healthcare services industry in the country and accounts for about more than half of the industry's size. The services offered under hospitals reach the population through two routes, public and private. While the public sector provides treatment by means of sub-centres, primary health centres (PHC), community health centres (CHC), district hospitals and government-funded institutions, private sector provides services through clinics, mid-size secondary and tertiary hospitals.

The structure of healthcare delivery system in India consists of three broad segments: Primary care, Secondary care and Tertiary care.

Primary care is the first point of contact between the population and the healthcare service providers. This infrastructure offers basic medical and health preservation 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 healthcare delivery system in the country. These hospitals are specialised consultative healthcare infrastructure which has 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 a number of services in the same hospital.

Rating Methodology

CARE Ratings has a well laid out broad methodology for rating of entities belonging to the manufacturing sector/ services sector. This methodology attempts to point out factors, over and above, those mentioned in the broad methodology, which are considered while analyzing the entities belonging to the hospital sector. CARE's rating methodology identifies five key rating considerations that drive credit rating of the hospital entities:

- Promoters/management analysis
- Business risk analysis
- Financial risk analysis
- Risk associated with ongoing/upcoming projects
- Regulatory / Event risk

Promoters/Management Analysis

Hospital business is capital-intensive in nature 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 in a timely manner is crucial. Furthermore, the strong group presence/parentage would result in enhanced financial flexibility. The rating methodology for hospital entities considers commitment of the promoters not only in the form of equity but also their active involvement in the management of the entity, reflecting the importance of the entity in the overall group's portfolio. In case the hospital entities which are promoted by medical professionals, experience and track record of the promoters are viewed positively. Availability of further equity for expansion, modernisation can however become limiting factor for credit profile unless resources are tied up.

Business risk analysis

- **Scale and diversification**

  As mentioned above, there are primary, secondary and tertiary level health care providers based on requirements in the catchment area. A higher level hospital is able to keep more patients and not required to refer out patients for services not provided by it. Also specialists tend to prefer recruitment at such hospitals as they gain more patients. Hence broad spectrum of services is important credit perspective. CARE Ratings considers scale of business operations in terms of bed inventory and geographic coverage of the entity i.e. the entity's presence in the number of cities in India and overseas. In CARE's view, diversification (multiple locations and specialties) and scale are important rating considerations since they provide revenue stability and lead to economies of scale in business operations, marketing and distribution. In case of hospital chains, CARE also looks at the revenue growth rate for each unit as well as profitability. The mix of revenue from matured and recently established hospital unit is examined as matured hospital unis tend to provide better profitability with stable revenue. While assessing diversification risk, concentration of 'doctors / specialists' is also seen. If there is revenue concentration attributable to particular doctor / consultant / specialists, the hospital would remain exposed to attrition risk. Diversity of revenue streams and presence of succession planning mitigate this risk to some extent.

- **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. The cost per bed is also impacted due to location. Apart from this, CARE also takes into account competition from the hospitals located nearby and the services offered by them. Overall location analysis helps in assessing ability to generate sufficient surplus cash flows for debt servicing.

- **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 larger number of patients and renowned doctors. A better brand image and competitive position not only ensures a higher market share, it 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 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. Presence of renowned doctors who are skilled and have earned reputation in the market over years tend to attract a higher number of patients and can help hospitals to charge premium for the services provided by them. Similarly, hospitals with renowned accreditations such as National Accreditation Board for Hospitals & Healthcare

Providers (NABH)[1] and Joint Commission International (JCI) [2]do command a better competitive position.

- **Channels of payment**

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 evaluates the percentage of revenue from each of the channel and reimbursement trend in order to ascertain the health of its cash flows. In CARE's view, a hospital with more of cash business will have better cash flow as compared to more of CGHS/TPA business wherein the payments are realized with delay. The revenue from government schemes / institutional clients imparts sustainability of revenue but impacts profitability and working capital cycle.

CARE also evaluates the revenue mix of a hospital in terms of domestic and international patients. A higher percentage of contribution of international patients ensures healthier profitability for hospitals.

- **Operating performance**

CARE Ratings analyzes performance indicators of hospitals such as ARPOB (Average Revenue per Occupied Bed), ALOS (Average Length of Stay) and occupancy ratio.

ARPOB refers to the average revenue realized by a hospital from every occupied bed. ARPOB depends on 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 and linkage between ARPOB trend and 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 result in more patients to be 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.

1 National Accreditation Board for Hospitals & Healthcare Providers (NABH) is a constituent board of Quality Council of India, set up to establish and operate accreditation programme for healthcare organisations.

2 The Joint Commission is a United States-based organization that accredits more than 21,000 US health care organizations and programs. The international branch accredits medical services from around the world.

Financial risk analysis

CARE follows its standard ratio analysis methodology for non-financial sector in order to assess the financial risk of entities in the hospital sector. The hospital entities are exposed to foreign exchange (forex) risk to the extent of imported equipment through Letters of Credit, or foreign currency loans. The revenue from international patients may act as natural hedge if available. CARE examines hedging policies adopted by the management to mitigate forex risk.

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 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 time of 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 possibility of time and cost overrun.

CARE Ratings also considers the management's 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 is assessed. Due to 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 analyzes the source of funding and its consequent impact on the capital structure on the entity.

Regulatory / Event Risk

Hospitals operate in a regulated industry. In India, hospitals are governed by various laws such as Indian Medical Council Act 1956, The Clinical Establishments (registration and regulation) Act 2010, Indian Medical Council Regulations 2002 etc. Given the importance of healthcare facilities, Government of India has been taking various steps towards increasing the affordability and coverage of healthcare services in the country by putting price restriction on pharmaceutical entities, medical equipment manufacturers and hospitals services. One of the biggest was the cut in the price of stents and knee implants in 2017 by over 70%, besides the regular revision of the provisions of the Drugs and Cosmetics Act. Various state governments have also implemented the Clinical Practice Establishment Act, bringing in accountability on how hospitals price their cost of services to patient, and penal provisions for violations.

Thus, CARE views regulatory risk to be a critical for hospital operations and continuously monitor its impact on the operations, business continuity, impact on profitability and eventual credit profile. The demonstrated ability of the entity to respond to such event risk; which may arise due to natural / accidental calamities or unfavourable judgment which is not covered by insurance, is taken into consideration.

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 credit quality of the issuer. While the methodology encompasses comprehensive technical, financial, commercial, economic and management analysis credit rating is an overall assessment of timely debt servicing by the issuer.

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