Rating Agency Perspective: Review of Moody's Scorecard

As healthcare systems consider capital structure needs in an evolving economic and public health environment, the first question is often, "What's our credit profile?" Rating agency "scorecards" attempt to offer transparency and consistency to what is a multi-layered quantitative and qualitative analysis. How closely do these scorecards predict actual ratings, though? Ponder has some thoughts.

Background

In 2012, following the enactment of the Dodd-Frank Act, Moody's began publishing an indicative scorecard to provide insight into its rating methodology. Qualifying the usage of the tool, Moody's states that "The scorecard in this methodology is the starting point for the consideration of a rating. It is neither a rating calculator nor a comprehensive list of all factors affecting the rating." The tool is widely used as an informative analytical exercise to test possible rating outcomes based on various financial ratio quantitative inputs as well as several subjective qualitative inputs.

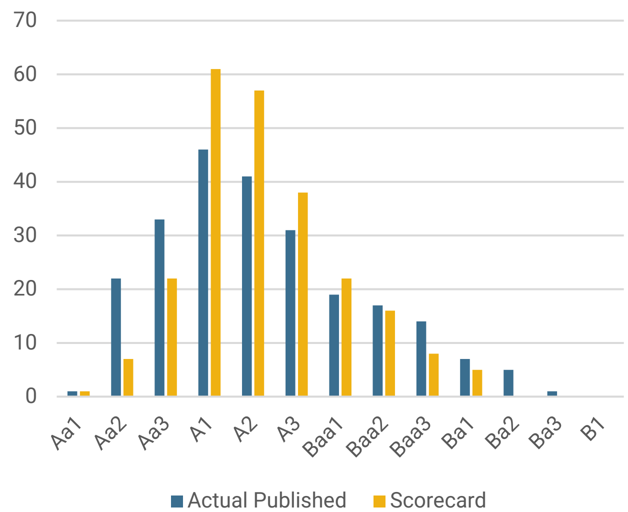
After several years of incorporating the scorecard into credit analyses, Ponder has developed several impressions: 1) there is significant rating upside for sizeable entities with high topline growth (including same store growth), 2) the scorecard outcome typically falls within one notch of a hospital's actual rating, and 3) deterioration in one or a few ratios may not change the scorecard outcome given the positive offset of other ratios.

To test our observations, Ponder conducted an analysis of 237 not-for-profit healthcare entities categorized as Multi-State, Single-State, Standalone Facilities, Academic Medical Centers, and Children's Hospitals, as defined by Moody's. Sourcing the agency's Municipal Financial Ratio Analysis ("MFRA") database, we analyzed Fiscal Year 2020 results (full FY 2021 results are not yet available) in the scorecard by comparing the values to actual Moody's ratings. Below are several observations we gathered from the analysis.

Observation #1: Credits with 'Aa' and strong 'A' ratings tend to be rated higher than their scorecard value. Lower credits with 'A' and 'Baa' ratings tend to be rated lower than their scorecard value

It is important to note that rating analysts rate entities relative to others in the same industry. In other words, a healthcare system rated 'A1' is compared to other healthcare systems and not corporate entities rated 'A1.' This results in a bell curve shaped rating distribution. Further, the distribution curves of both actual and scorecard values are generally shaped the same – both show most entities fall into the 'A1' and 'A2' ratings. However, the actual rating distribution curve has less steepness between 'Aa2' and 'A1.' This demonstrates the observed boost effect for several 'AA' category entities that have a scorecard value in the high 'A' category. Furthermore, the actual rating distribution curve not only has less steepness between 'A2' and 'A3,' but it also has a longer "tail" with more entities actually rated Baa3 or lower vs. the scorecard. This indicates additional rating pressures on weaker credits that result in lower ratings.

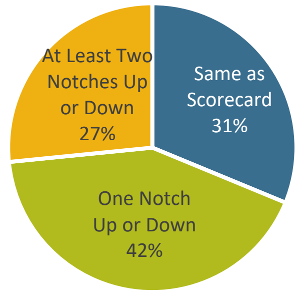
Rating vs. Scorecard Distribution Comparison (237 entities)



Actual Rating	Number of entities	Actual Rating is Lower than Scorecard Value	Actual Rating is the same as Scorecard Value	Actual Rating is Higher than Scorecard Value
Aa1	1	0%	100%	0%
Aa2	22	0%	18%	82%
Aa3	33	9%	30%	61%
A1	46	0%	50%	50%
A2	41	24%	46%	29%
A3	31	58%	26%	16%
Baa1	19	53%	21%	26%
Baa2	17	71%	12%	18%
Baa3	14	93%	0%	7%
Ba1	7	57%	43%	0%
Ba2	5	100%	0%	0%
Ba3	1	100%	0%	0%

Observation #2: 73% of Entities Score the Same or Within One Notch of their Actual Rating

The scorecard value provides useful directional feedback of a borrower's rating outcome, within one notch. We noted that variations of two or more notches are more common among weaker 'A' and 'Baa' category entities. The following two observations attempt to look for contributing factors or patterns that may explain variances in the ratings versus the scorecard value, focusing specifically on entities rated 'Aa3' and 'A3.'



Observation #3: Many 'AA' and Strong 'A' Rated Systems are Buoyed by Revenue Size and Strong Balance Sheet Metrics

What allows credits to achieve a higher rating than their scorecard? Focusing on entities that have an actual rating of 'Aa3' but a lower scorecard value, 19 out of the 20 entities had total revenue in the 'Aa' category. The single entity that had an 'A1' score for revenue size had a 'Aaa' score for Days Cash on Hand and Cash to Debt. Moody's highly values sizeable entities given revenues account for 25% of the scorecard. Balance sheet metrics further boost the credit position, particularly Cash to Debt. While FY 2020 stressed the operational health of many entities, significantly weak operations generally did not jeopardize the ratings of 'Aa' credits given the factors above as well as the unique and potentially one-time nature of COVID related events. While operational profitability remains the foundational strength of any healthcare credit, highly rated credits may have more flexibility in maintaining their rating than lower rated credits in times of weak performance.

'Aa3' Entities whose Scorecard Values are 'A1' or Lower (20 entities)

Entities Actual Rating	Scorecard Value	Total Revenue	3yr CAGR	Op. Cash Flow Margin	Medicare / Medicaid %	DCOH	Cash to Debt	Debt to Cash Flow
Aa3	A1	Aa3	A3	Baa1	SG	Aa2	Aa1	A1
Aa3	A1	Aa3	SG	Aa3	Baa2	Aaa	Aaa	Aa3
Aa3	A1	Aa3	A3	A3	Baa3	Aaa	Aa1	Aa3
Aa3	A1	Aa3	Aa2	A2	Baa2	Aa2	Aa3	A2
Aa3	A1	Aa3	A2	Baa3	A3	A2	Aa3	A2
Aa3	A1	Aa2	Aaa	Baa3	SG	A1	Aa1	A1
Aa3	A1	Aaa	A3	SG	Baa1	A1	Aa2	A3
Aa3	A1	A1	A3	SG	A2	Aaa	Aaa	A1
Aa3	A1	Aa2	A2	Baa1	Baa3	Aa1	Aa2	A2
Aa3	A1	Aa3	A3	Baa3	SG	Aa1	Aaa	Aa2
Aa3	A1	Aa3	Baa1	A1	Baa2	Aaa	Aa2	A1
Aa3	A1	Aa2	A1	SG	A3	Aa3	A1	Baa3
Aa3	A1	Aa3	A2	Baa1	A3	A1	Aa1	Aa2
Aa3	A1	Aa1	Aa3	Baa3	A3	A1	Aa3	A3
Aa3	A1	Aa3	Aa3	Baa3	Baa1	A1	Aaa	Aa3
Aa3	A1	Aa3	Aa2	Baa3	Baa2	Aa3	Aa3	A3
Aa3	A2	Aa2	SG	SG	Baa1	Aa3	Aa1	A2
Aa3	A2	Aaa	SG	SG	A2	Aa2	Aa3	SG
Aa3	A2	Aaa	Baa3	Baa2	Baa3	A1	A2	Baa1
Aa3	A2	Aa2	A1	SG	Baa3	Aa3	Aa2	Baa2

Observation #4: Weak Operating Cash Flow Margins Place Greater Pressure on Lower Rated Credits

What causes credits to be rated lower than their scorecard? Looking at entities whose actual rating is ‘A3’ but with a more favorable scorecard value, approximately 65% of the sample scored ‘A3’ or below for Operating Cash Flow Margin. Furthermore, revenue size and balance sheet metrics less frequently provided a positive offset to ‘A3’ credits’ weaker operational metrics than was the case for the ‘Aa3’ credits analyzed above.

‘A3’ Entities whose Scorecard Values are ‘A2’ or Better (18 entities)

Entities Actual Rating	Scorecard Value	Total Revenue	3yr CAGR	Op. Cash Flow Margin	Medicare / Medicaid %	DCOH	Cash to Debt	Debt to Cash Flow
A3	A1	Aa3	Aa2	A3	A3	A1	A1	A3
A3	A1	Aa3	Aa3	A2	A3	Baa1	A2	Aa3
A3	A1	Aa2	Aaa	Baa3	Baa1	A2	Aa2	A1
A3	A1	Aa2	Aaa	A1	Baa1	A3	Baa2	A2
A3	A1	A3	A1	A1	Baa1	Aa2	Aaa	Aa1
A3	A2	Baa1	A1	Baa2	SG	Aa2	Aa1	A1
A3	A2	Aaa	Aa2	SG	Baa3	Baa1	A3	A3
A3	A2	Aa3	A2	SG	Baa2	Aa2	Aa3	Baa3
A3	A2	Aa3	Aaa	A2	SG	Aa2	A2	Baa1
A3	A2	Aa3	Aa1	Baa1	Baa1	A1	A3	Baa3
A3	A2	Aa3	Aa1	Baa2	Baa2	A2	A3	Baa2
A3	A2	Aa2	Aaa	A3	Baa2	A3	Baa1	Baa1
A3	A2	Aa2	A1	Baa2	A1	A3	Baa1	Baa1
A3	A2	A3	A1	Aa3	Baa3	Aa2	Aa3	A1
A3	A2	A3	Baa3	Baa1	Baa2	Aa3	Aaa	Aa2
A3	A2	A3	A1	A3	A3	A1	A2	Baa1
A3	A2	A3	A1	A2	Baa1	A1	Aa3	Aa3
A3	A2	A2	Aaa	Baa2	A2	A2	A3	Baa2

What does this mean for our clients?

The Moody’s scorecard provides helpful insights into current rating drivers. Based on the data, strong ‘Aa’ and ‘A’ rated credits tend to see more upside potential in their actual rating vs. scorecard metrics. Lower ‘A’ and ‘Baa’ credits may be more vulnerable to pressures that push their ratings below scorecard metrics. While the analysis above was based on FY 2020 results, FY 2021 rating actions appear to show overall rating stability.

As healthcare providers continue to navigate industry and individual market headwinds, Ponder can help plan for potential rating impact. We will continue to assist clients with insights into the data and market trends that may shape their credit presentation as well as guide management in strategic decision making.

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