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Why Does Your Bond Rating Matter?

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Marian C. Jennings, President
M. Jennings Consulting, Inc.

Ensuring ongoing access to capital is one of the biggest challenges facing not-for-profit health care organizations today. Most larger hospitals and health systems access capital in large part through tax-exempt debt vehicles, relying either on their own creditworthiness and/or obtaining credit enhancements. Credit evaluations or bond ratings are performed primarily by three large rating agencies: Standard & Poor's (S&P), Moody's Investors Services, and Fitch Ratings. A question many Trustees may ask is, "Why does the credit rating matter, as long as we have access to capital when we need it?"

While this is a reasonable question, ample evidence suggests that bond ratings – in and of themselves – matter a great deal. Essentially, a bond rating is an objective assessment of the long-term financial viability of an organization, whether a hospital, a health system, a high tech firm, or a long-established manufacturer. While the ratings are driven by financial performance, they are not determined by the numbers alone. Instead, ratings also reflect the agencies' assessments of the depth and breadth of management, the credibility of the organization's strategic plan, and the organization's market position and stability. Each of these should also be of great interest to Trustees.

In addition, if Trustees see themselves – as they should –as stewards of resources that ultimately belong to the communities they serve, then bond ratings are a good "yardstick" to

measure how well the Board and senior management are exercising these stewardship responsibilities. In other words, today's Boards should be making decisions that provide financial flexibility to the next generation of Board leaders ten to fifteen years down the road.

It is interesting to note the strong ratings of the large, multi-state Catholic health systems. While their credit strength depends on numerous factors such as their size and diversified nature of their risk due to their geography, their strength can be attributed in no small part to their founders' longitudinal view of their purpose or mission. The founding sisters were carrying on a ministry purpose 2,000 years old – they realized early on the importance of financial strength in ensuring the *long-term* vitality of their organizations (the phrase "no margin, no mission" is generally attributed to a sister). In 2004, six of the ten largest Catholic health care systems held a bond rating of AA- or greater, compared with only 13.5% of the 569 rated hospitals and systems.[1]

Why Ratings Matter

As indicated in Exhibit 1, there are five practical reasons that the rating of your organization matters.

Exhibit 1
Why Bond Ratings Matter

Stronger Credits:

- Enjoy lower financing costs
- Have greater access to capital and more available financing alternatives
- Are subject to fewer and/or less restrictive debt covenants
- Have greater long-term financial flexibility
- Demonstrate "best (financial) practices"

First, hospitals or systems with a stronger credit rating enjoy lower interest rates, reflecting their lower risk of defaulting on their debt. For example, a 2004 study[2] by Donald Carlson of the Ziegler Company indicated that, between June 2000 and June 2004, the difference in interest rates between organizations with an underlying credit rating of A and those with an underlying rating of BBB ranged between 40 and 90 basis points (a basis point is 1/100th of one point of interest). Assuming the low end of that range, a hospital or health system borrowing $50 million over 30 years would save approximately $4.5 million over the life of the borrowing. While not monumental, these are real costs that could be avoided by having a stronger credit rating.

Second, stronger credits have greater access to capital along with more financing alternatives. For example, most credit enhancers (bond insurers such as AMBAC and MBIA, which are rated AAA, will, for a fee, provide credit enhancement) now require that a hospital or system warrant an underlying rating of at least A (S&P, Fitch) or A2 (Moody's). Almost 60 percent of all health care organizations rated by S&P in 2004 failed to meet that standard[1] and therefore did not have that option. In addition to credit enhancement options, stronger credits also have more access to creative financing structures, such as variable rate debt, as well as the ability to fund projects with cash and wait for a more favorable financing market.

Third, stronger credits are subject to fewer and/or less restrictive covenants related to liquidity (e.g., minimum days cash on hand), balance sheet strength (e.g., maximum capitalization ratio), or coverage (e.g., minimum debt service coverage) ratios.

In addition, while perhaps not as quantifiable or tangible a short term benefit, stronger credits have greater long-term financial flexibility to withstand an increasingly hostile and volatile health care environment. Boards should not overlook this benefit. Effective Boards take comfort in knowing that their decisions have positioned their organizations well to "weather the storms" of major capital investments in an era of declining payment, ever-rising health care costs, and increasing numbers of uninsured and underinsured. Organizations with more flexibility can ensure that they balance mission and margin, rather than treat these as an "either/or" proposition.

Finally, many organizations have adopted a culture of "best practices" or benchmarking regarding quality and safety. The same concept can be applied to financial performance, where the "best practices" relate to the financial ratios achieved by those health care organizations in the AA category. These not-for-profits are demonstrating what can be accomplished despite a financially challenging environment. Even if such performance is out of reach for an organization today, benchmarking against the best will yield improved performance both short- and long-term.

Conclusions

Whether your organization has a rating already, is rated but uses a credit enhancement to go to market, or stands on its own strong credit, bond ratings matter. Even if you never expect to be rated, your organization can use the financial ratios of a targeted rating category as an aspirational benchmark. If your organization has been or is seeking a rating, the Board will benefit from learning from an objective third party exactly how financially healthy the organization is.

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[1] Standard & Poor's, "U.S. Not-For-Profit Health Care 2004 Median Ratios."
[2] Carlson, Donald A., Jr. 2004. "Access to Capital – A Growing Concern." *Frontiers of Health Services Management*, 21:2. p. 27. Chicago: Health Administration Press.