

How Do Rating Agencies Evaluate Your Management Practices?

By: John L. Hess

Ask healthcare executives to identify their biggest concerns, and one of the issues likely to be high on the list is lack of access to adequate capital. Faced with rising costs, inadequate payment, and increasing demand for capital, hospitals' credit positions are starting to decline. According to the Moody's Investor Service August 2003 publication *Not-For-Profit Healthcare: 2003 Outlook and Medians*: "The not-for-profit healthcare industry is moving toward a negative outlook and away from rating stability with the expectation that the industry will face greater credit volatility over at least the next one to two years."

In such an environment, a positive credit rating is more important than ever. Rating agencies make their decisions based on a hospital's financial performance and market factors, but the quality and effectiveness of management and governance are also critically important in rating decisions. With the major scandals that have plagued the corporate world in recent years, the rating agencies are taking a closer look at how they evaluate management and governance.

Good Management and Governance

Everyone agrees that good management and governance are important, but how do you define and measure them? Senior analysts at the rating agencies acknowledge that evaluating management and governance is subjective.

Governance. Because the board is ultimately responsible for ensuring an entity's financial health, rating agencies pay a great deal of attention to the structure and role of the board. Moody's looks for boards that "take an active, though not meddlesome, role" in governing the organization.

Pamela Federbusch, senior vice president in Moody's healthcare group, underscores the importance of proper governance oversight. "Enron scared everybody!" she said in a recent interview for this article. According to Federbusch, boards all too often are "still not the leaders" that they need to be. Her advice to board members is to understand your market, niche, and competitive position. She also stresses the need for a board to hold management and itself accountable. Additionally, she recommends that board members participate in continuing education programs on important industry issues.

Management. The quality of management is difficult to measure, but important. According to Moody's Federbusch, the depth of the management team is an essential factor, as is commitment to the same vision among the entire management team. A lack of commitment and passion from members of the management team is a red flag signaling a need for improvement, according to Federbusch.

Moody's identifies the following as specifics of effective management:

- * A coherent long-range strategic plan
- * Clearly articulated debt and investment-management policies
- * Realistic budgeting and monitoring practices

- * Past record of successfully handling difficult situations
- * Ability to achieve favorable results, such as a stable market position and balanced operations

Martin Arrick, managing director of Standard & Poor's healthcare group, also emphasized the growing importance of management evaluation, although admitting that management is still "a bit touchy-feely." Arrick identified the following items as important indicators of sound management:

- * Business planning
- * Track record
- * Ability to prune under-performing business lines
- * Relationships with the medical staff
- * Depth of management staff

The rating agencies agree that open communication with the agencies and investors is critical. To a significant degree, rating agencies base their evaluations of management on the relationship the agencies have with the entity's managers. These agencies also agree that the worst thing that can happen is a "surprise" or unexpected financial development. For this reason, hospital management should keep rating agencies informed about an organization's performance.

Moving Toward More Objectivity

Although the evaluation of management and governance will always be subjective, there seems to be a trend toward more objective measurement by the rating agencies. Fitch Ratings documented the relationship between management quality and financial performance in its May 4, 2000, study, *Impact of Management Practices on Municipal Credit*. This study concluded that, “In analyzing actual financial crises over the past 25 years, it is clear that management has had a significant impact in salvaging, as well as exacerbating situations.”

Over the past two years, Fitch Ratings has published updated versions of its *12 Habits of Highly Successful Finance Officers* (November 2002) for governmental entities and *Best Management Practices in Higher Education* (February 2003). Although these reports do not address health care specifically, they offer a glimpse at some of the criteria that a rating agency can use to evaluate management. Those criteria include:

- * Dissemination and adherence to a strategic plan
- * Integrated modeling of key variables
- * Monthly or quarterly financial reporting and monitoring
- * Multiyear financial forecasting
- * Existence of a long-term capital improvement plan
- * Existence of a debt policy (liability management) and investment policy (asset management)
- * Fund balance reserve policy/working capital reserves
- * Adherence to an endowment spending policy

- * Active board participation and discussions with staff
- * Superior disclosure practices

Although these criteria don't define exemplary management practices, they do suggest competent management practices that can be objectively identified. In a recent interview, Fred Martucci, managing director in Fitch Rating's healthcare and higher education group, stressed that Fitch's "emphasis is on management practices, not people—on what's going to survive the people." Martucci added that "we have no 'check-off list' that we go over in committee." The best practices that Fitch Ratings is developing help focus the analysis and discussions on the objective practices identified.

Fitch Ratings plans to publish criteria for effective healthcare management practices in 2004. According to Martucci, some of the key healthcare practices will address strategy (clear objectives, goals, and check points), asset/liability management policies, budgeting process, and personnel-management process.

Healthcare Executive Applications

Healthcare executives approach the credit markets to seek capital for their organizations in much the same way as their counterparts in corporate America. They hold the responsibility of stewardship to investors and the rating agencies that provide information to investors. Healthcare executives need to realize the importance of the investor and rating agency relationships and cultivate a culture of credibility and openness of communications with these important constituencies.

Maintaining a good credit rating is critical to capital access. The quality of the organization's governance and management of the organization is an important element in the credit-rating process. Organizations that demonstrate effective strategic and business planning, governance oversight, capital planning, financial management, and disclosure practices will earn favorable rating-agency reviews related to management and governance.

Developing management credibility with the rating agencies and investors is not a function of personality or showmanship; it's a function of establishing good management practices, being flexible enough to change and adapt quickly when needed, and achieving sustainable long-term results. Executives can learn from the rating agencies' emphasis on management and governance and seek ways to incorporate the best of these practices into their organizations' culture and day-to-day operations, and to demonstrate continuous improvement.

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