Revised Criteria for U.S. Not-For-Profit
Acute-Care Stand-Alone Hospitals

Speakers:

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Agenda

Objective
Scope
Implementation
Changes Since the Request for Comment
Analytical Framework
Additional Resources
Objective

The revised criteria are intended to:

• Provide transparency into our rating process
• Enhance ratings comparability
• Formalize the forward-looking nature of rating components
Implications are moderate – mostly 1 notch

Ratings on as much as 10% of portfolio could be raised

Ratings on as much as 15% of portfolio could be lowered

Scope of the Revised Stand-Alone Hospital Criteria

• Not-for profit, acute-care stand-alone hospitals
  ~400 ratings

• Applies to issue ratings and ICRs

  • Multi-hospital health systems
  • Human service providers
  • Senior living facilities

The majority of ratings are expected to remain the same (estimated at least 75%)

Implications are moderate – mostly 1 notch

↑ Ratings on as much as 10% of portfolio could be raised

↓ Ratings on as much as 15% of portfolio could be lowered
We intend to complete our review of issuers affected within 12 months of the effective date of the new criteria.

- **Week of December 15, 2014**
  - Revised rating methodology for hospitals published

- **By June 30, 2015**
  - Review hospitals where initial testing suggested one or more notch rating change

- **By December 15, 2015**
  - Review all remaining hospital ratings
Changes since the Request for Comment

• Since our Request for Comment in December 2013, we have made changes based on market feedback and further refinements of the methodology based on extensive testing.

• Summary of Changes:

  Scope, Adjustments, And Overrides
  • Provided clarification regarding the definition of a healthcare system and applicable criteria, the peer comparison adjustment and override factors used to arrive at the indicative rating.

  Enterprise Risk Profile Factors
  • Added and/or refined rating factors regarding country risk, inpatient admissions, physician admission concentration, payer mix, governance, and clinical quality.

  Financial Risk Profile Factors
  • Added and/or refined rating factors regarding potentially sizable capital plans, net patient revenue, and reliance on special funding.

• For a complete summary of changes, please refer to the following article: RFC Process Summary: Rating Methodology And Assumptions For U.S. Not-For-Profit Acute-Care Stand-Alone Hospitals
Changes since the Request for Comment (continued)
Scope, Adjustments, And Overrides:

• In our revised criteria, we updated our definition of a multihospital health system. A multihospital health system must meet one of the following definitions:
  • Three or more hospitals and operating revenue in excess of $1.5 billion; or
  • At least $750 million total operating revenue and at least one of the following characteristics:
    • Three or more hospitals in two or more states;
    • Three or more hospitals in a single state where the largest hospital's operating revenue does not exceed 65% of total operating revenue;
    • Four or more hospitals in a single state with about 15% of total operating revenue from non-acute care businesses including but not limited to psychiatry, rehabilitation, health insurance plan, or long term care; or
    • Ten or more hospitals

• Health systems will be rated under existing criteria. Hospitals and health systems that do not meet the above definition will be rated based on the scope of the revised stand-alone hospital criteria.
Changes since the Request for Comment (continued)

Scope, Adjustments, And Overrides:

- **Peer Analysis** - The revised criteria provide for a one-notch adjustment between the indicative rating and the final rating based on a holistic view of the credit, which may be informed by peer analysis. We added information to help the market understand what standards we will use to identify peers for the purposes of comparative credit analysis. We also clarified that the holistic view of the credit may include characteristics that are unusually strong or weak or not otherwise measured in the criteria factors and sub-factors.

- **Overrides to Initial Indicative Rating:**
  - **Unrestricted Reserves:**
    - Favorable override for high reserves where those credits that don’t have unusually low debt levels;
    - Second ratings cap of ‘BBB+’ added to the low unrestricted reserves override for credits with less than 75 DCOH
  - **Small Hospitals:** Lowered threshold for small hospitals to $125 million NPSR (from $150 million)
  - **Children’s hospitals** will not be considered specialty hospitals, no negative adjustment, because we believe most children's hospitals offer a full range of clinical specialties similar to an adult medical/surgical hospital.
  - **Tax-Supported Hospitals:** limited positive adjustment to two notches from three - based on further testing, we believe that the benefits from tax support, while important, do not warrant a full rating category difference between the initial indicative rating and the indicative rating, particularly when many districts are often reluctant to or precluded from increasing tax levies. However, some flexibility remains for those hospitals which receive tax revenue or capital support and subsequently can operate with a more modest financial profile than other similarly rated hospitals.
Changes since the Request for Comment (continued)

Enterprise Risk Profile Factors:

- **Country Risk:** because the relevant credit risks for hospitals are also influenced by country-specific risks, we have added information about how our assessment of country risk can limit the enterprise profile score. We do not anticipate any near-term impact on the criteria from the inclusion of country risk.

- **Outpatient Presence:** because the health care industry is rapidly shifting from inpatient-based care to outpatient care, we added a qualitative factor with a positive impact on the initial assessment under the market share, competition, and demand section which applies to stand-alone hospitals with an outsized outpatient presence relative to their inpatient business.

- **Medical Staff:** assessment of ‘5’ is now possible when there is physician admission concentration among the top 10 admitters for hospitals with fewer than 7,500 admissions. The better score would be allowed only for cases when individual physicians comprising the top 10 are largely under the age of 60 and successor physicians have already been recruited.

- **Payer Mix:** minor changes to better reflect our view of risk associated with a high concentration of governmental payers.

- **Clinical Quality & IT:** adjusted weightings to increase the importance of outcomes measures and decrease the important of process of care measures.

- **Governance:** negative assessment is not always required when more than 20% of a board is seated based on position held or affiliation with a related organization (outside appointees). Because we have rarely seen outside board appointees negatively affect board performance, this change provides analytical flexibility to keep the governance score at neutral in cases where the board has outside appointees, but is otherwise meeting our governance measures.
Changes since the Request for Comment (continued)

Financial Risk Profile Factors:

- **Potentially sizeable capital plans:** adjustment added for use in cases where an organization has a large, but currently unspecified, capital plan that we believe will include sizable debt plans or use of unrestricted reserves. This adjustment allows us to generally reflect the rating risks associated with future additional debt and unrestricted reserve changes on the balance sheet even if management lacks or is unable to share specific plans.

- **Revenue Diversity:** Positive adjustment - for hospitals with NPSR over $600 million and where the main hospital and employed physician revenue is not greater than 85% of total operating rev. – we think the adjustment can be used to recognize increased stability and diversity possessed by larger stand-alone hospitals, which often have health system-like characteristics and a broader and more diverse range of services than typical stand-alone providers.

- **Special Funding:** Negative adjustment - many hospitals receive special funding from the federal and state government primarily for serving a higher-than-usual number of Medicaid or charity care patients. Because the amount of funding received changes annually and because there is inherent legislative risk associated with most programs, there is a negative qualitative adjustment to the financial performance assessment recognizing the uncertainty of this funding source for those hospitals receiving special revenue. However, recognizing that many of these funding sources have a long history, we amended the adjustment so that it only applies to hospitals whose operating income would be negative if half the special revenue were eliminated. Further, the negative adjustment would be made only to those hospitals where special revenue is a meaningful percent of operating revenue and is more than a nominal dollar amount.
Analytical Framework
Reference
Analytical Framework

- Industry risk: 20%
- Economic fundamentals: 20%
- Market position: 50%
- Management and governance: 10%

Enterprise profile (Assessment 1-6)

Initial Indicative Rating

Matrix

1 2 3 4 5 6

Overriding factors

Peer Comparison

Indicative Rating

Final rating

Financial profile (Assessment 1-6)

- Financial policies: not weighted
- Financial performance: 40%
- Liquidity and financial flexibility: 30%
- Debt and contingent liabilities: 30%
Determining the Initial Indicative Rating

The initial indicative rating results from the interaction between the enterprise and financial profile assessments. Potential adjustments to the initial indicative rating are noted in table 2 of the criteria. The final rating will be within one notch of the indicative rating with the one-notch difference attributable to peer adjustments. For ratings below ‘B-’ see “Criteria For Assigning ‘CCC+’, ‘CCC’, ‘CCC-’, And ‘CC’ Ratings”, published Oct. 1, 2012.

<table>
<thead>
<tr>
<th>Enterprise Profile</th>
<th>Financial Profile</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Extremely strong</td>
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<tr>
<td></td>
<td>Very strong</td>
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<tr>
<td></td>
<td>Strong</td>
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<td>Adequate</td>
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<td>Vulnerable</td>
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<td>Highly vulnerable</td>
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<td>6</td>
<td>bbb-</td>
<td>bb-</td>
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</tbody>
</table>

The initial indicative rating results from the interaction between the enterprise and financial profile assessments. Potential adjustments to the initial indicative rating are noted in table 2 of the criteria. The final rating will be within one notch of the indicative rating with the one-notch difference attributable to peer adjustments. For ratings below ‘B-’ see “Criteria For Assigning ‘CCC+’, ‘CCC’, ‘CCC-’, And ‘CC’ Ratings”, published Oct. 1, 2012.
Analytical Framework – Determining the Final Rating

Enterprise profile (Assessment 1-6)
- Industry risk: 20%
- Economic fundamentals: 20%
- Market position: 50%
- Management and governance: 10%

Financial profile (Assessment 1-6)
- Financial policies: not weighted
- Financial performance: 40%
- Liquidity and financial flexibility: 30%
- Debt and contingent liabilities: 30%

Initial Indicative Rating

Matrix

1 2 3 4 5 6
1
2
3
4
5
6

Indicative Rating

Positive Overriding Factors
1. Extraordinarily high reserves (1 notch adjustment)
2. Academic medical center with closely related higher rated university (1 notch adjustment)
3. Tax supported hospital (up to 2 notch adjustment)

Negative Overriding Factors
1. Lack of willingness or potential bankruptcy filing (caps rating)
2. Credit emerging from financial crisis (caps ratings)
3. Weak management (up to 3 notch adjustment)
4. Extraordinarily low reserves (caps rating)
5. Limited revenue base (1 notch adjustment)
6. Specialty hospitals (1 notch adjustment)

Peer comparisons (1 notch adjustment, positive or negative)

Final rating

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Questions
Resources

For more information, go to www.standardandpoors/healthcare, and follow the link to “U.S. Not-for-Profit Healthcare”

- Video cast replay
- Credit Matters TV
- Published Articles
  - U.S. Not-For-Profit Acute-Care Stand-Alone Hospitals -- Methodology And Assumptions
  - How Standard & Poor’s Intends To Finalize Its U.S. Not-For-Profit Acute-Care Stand-Alone Hospital Criteria and Apply Them To Ratings
  - Credit FAQ: An Overview of Standard & Poor’s Updated Methodology for Rating U.S. Not-For-Profit Acute-Care Stand-Alone Hospitals
  - RFC Process Summary: Rating Methodology And Assumptions For U.S. Not-For-Profit Acute-Care Stand-Alone Hospitals
Thank You

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Appendix
• The enterprise profile assessment assesses the operating environment and incorporates broad industry factors as well as organization-specific factors.

• These factors have initial assessments ranging from 1 (best) to 6 (worst) based on data metrics.

• Qualitative factors provide the ability to adjust factor and sub-factors assessments by 1 or 2 points to account for characteristics not captured in the initial assessment.

• Total adjustments are based on the net of positive and negative qualitative factors.
1. Industry risk (20% of Enterprise Profile Assessment)
   We believe the health care services industry represents medium credit risk when compared to other industries and sectors. Aligned with criteria “Industry Risk”. Standard assessment.

2. Economic Fundamentals (20% of Enterprise Profile Assessment):
   The assessment measures the viability of the service area and the characteristics of the service area population.

3. Market Position (50% of Enterprise Profile Assessment)
   Assesses market share, medical staff, payer mix, and clinical quality & IT.

4. Management & Governance (10% of Enterprise Profile Assessment)
   Aligned with criteria: “Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers”
## Economic Fundamentals – Qualitative Factors

### Qualitative Factors With Positive Impact
- Projected population growth > 2x U.S. growth rate
- Projected employment growth > 150% U.S. rate
- Projected per capita personal income > 125% of U.S. PCPI
- Institutional influence

### Qualitative Factors With Negative Impact
- Population projected to decline over the next 5 years
- Projected employment growth < half U.S. rate
- Projected per capita personal income < 75% of U.S. PCPI
- Employment concentration

### Assessing Economic Fundamentals

<table>
<thead>
<tr>
<th>Assessment</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
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<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary Service Area Population</td>
<td>&gt; 1.5 million</td>
<td>500,000 – 1.5 million</td>
<td>350,000 – 500,000</td>
<td>150,000 – 350,000</td>
<td>100,000 – 150,000</td>
<td>&lt; 100,000</td>
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</tbody>
</table>
## Enterprise Profile Assessment – Market Position: Market Share

### Preliminary Market Share, Competition and Demand Assessment

<table>
<thead>
<tr>
<th>Assessment</th>
<th>1</th>
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<th>6</th>
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<tbody>
<tr>
<td>PSA Population</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt;1.5 million</td>
<td>&gt;10%</td>
<td>8% -10%</td>
<td>6% - 8%</td>
<td>4% - 6%</td>
<td>3% – 4%</td>
<td>&lt;3%</td>
</tr>
<tr>
<td>&gt;500,000</td>
<td>&gt;45%</td>
<td>35% - 45%</td>
<td>25% - 35%</td>
<td>15% -25%</td>
<td>10% -15%</td>
<td>&lt;10%</td>
</tr>
<tr>
<td>&gt;350,000</td>
<td>&gt; 60%</td>
<td>50% - 60%</td>
<td>40% - 50%</td>
<td>30% - 40%</td>
<td>20% - 30%</td>
<td>&lt;20%</td>
</tr>
<tr>
<td>&gt;150,000</td>
<td>&gt;75%</td>
<td>60% - 75%</td>
<td>50% - 60%</td>
<td>35% - 50%</td>
<td>25% - 35%</td>
<td>&lt;25%</td>
</tr>
<tr>
<td>&gt;100,000</td>
<td>N.A.</td>
<td>&gt;70%</td>
<td>60% - 70%</td>
<td>45% - 60%</td>
<td>35% -45%</td>
<td>&lt;35%</td>
</tr>
<tr>
<td>&lt;100,000</td>
<td>N.A.</td>
<td>N.A.</td>
<td>&gt;65%</td>
<td>50% - 65%</td>
<td>40% - 50%</td>
<td>&lt;40%</td>
</tr>
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</table>

### Qualitative Factors With Positive Impact
- Projected increase in inpatient admissions > 15%
- Projected increase in equivalent admissions > 20%
- Greater than 2.5% increase in PSA market share which we believe is permanent
- Sole provider of a mainstream key clinical service or very broad service area definition
- Ratio of equivalent admissions to inpatient admissions is greater than 3.5
- CON
- Medical Staff score is a ‘1’

### Qualitative Factors With Negative Impact
- Projected decline in inpatient admissions > 5%
- Historic decline in inpatient admissions >10%
- No growth in historic or projected equivalent admissions
- PSA market share decline > 2.5% which we believe is permanent
- Narrowly drawn service area
- Excess hospital capacity in the service area
### Enterprise Profile – Qualitative Factors

<table>
<thead>
<tr>
<th>Qualitative Factor</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggressive policies and strategies, or operating in a rapidly changing competitive environment</td>
<td>Final enterprise profile assessment may be one point weaker than the initial enterprise profile assessment</td>
</tr>
<tr>
<td>Change in reimbursement, or change in competitive position not already factored into metrics</td>
<td>Final enterprise profile assessment may be one point lower or higher than initial enterprise profile assessment</td>
</tr>
<tr>
<td>Medical staff assessment is ‘6’</td>
<td>Final enterprise profile assessment may be capped at ‘4’</td>
</tr>
<tr>
<td>U.S. country risk assessment is ‘4’, ‘5’, or ‘6’</td>
<td>Final enterprise profile assessment may be capped at ‘4’, ‘5’, or ‘6’</td>
</tr>
</tbody>
</table>
The financial profile assessment evaluates the financial strength of the hospital.

These factors have initial assessments ranging from 1 (best) to 6 (worst) based on data metrics.

Adjustments provide the ability to adjust sub-factors and each of the assessments above by 1 or 2 points to account for characteristics not captured in the initial assessment.

Total adjustments are based on the net of positive and negative adjustments.
Financial Profile – Factor Details

1. Financial Policies (no weighting)
Assessment of hospital’s financial management and policies based on documentation from management and our discussions with them

2. Financial Performance (40% of Financial Profile Assessment)
• Measures how the absolute level and volatility of recent and projected earnings and cash flow could affect debt servicing capability. 6 sub-factors.

3. Liquidity and Financial Flexibility (30% of Financial Profile Assessment)
• Measures how cash flow and internal sources of unrestricted reserves may effect debt servicing capability. 5 factors.

3. Debt and Contingent Liabilities (30% of Financial Profile Assessment):
• Measures extent that current, proposed, contingent, and off-balance-sheet liabilities impact debt servicing capability. 4 sub-factors.
Measuring Financial Metrics

Financial metrics are based on three periods of data. Analyst chooses the method for the entire financial profile, not for individual metrics.

1. Most recent three audits
   • 45% weight to most current audit
   • 35% weight to 2nd year audit
   • 20% weight to 3rd year audit

2. Interims and 2 most recent audits
   • 20% weight to interims
   • 45% weight to most recent audit
   • 35% weight to 2nd year audit

Initial score for each metric is based on historic performance and the calculation method above.

Where we believe historic performance is not indicative of future, we can override any individual financial metric score.
## Assessing Financial Performance

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<tr>
<th>Assessment</th>
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<th>6</th>
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<tbody>
<tr>
<td>Net patient service revenue (Mil. $)</td>
<td>&gt;1,000</td>
<td>600-1,000</td>
<td>400-600</td>
<td>200-400</td>
<td>125-200</td>
<td>&lt;125</td>
</tr>
<tr>
<td>EBIDA margin (%)</td>
<td>&gt;18.0</td>
<td>14.0-18.0</td>
<td>12.0-14.0</td>
<td>10.5-12.0</td>
<td>9.0-10.5</td>
<td>&lt;9.0</td>
</tr>
<tr>
<td>Operating margin (%)</td>
<td>&gt;6.0</td>
<td>4.0-6.0</td>
<td>2.5-4.0</td>
<td>1.0-2.5</td>
<td>0–1.0</td>
<td>&lt;0</td>
</tr>
<tr>
<td>Excess margin (%)</td>
<td>&gt;9.5</td>
<td>7.5-9.5</td>
<td>5.0-7.5</td>
<td>2.5-5.0</td>
<td>1.0-2.5</td>
<td>&lt;1.0</td>
</tr>
<tr>
<td>Maximum annual debt service (MADS) coverage (x)</td>
<td>&gt;6.5</td>
<td>4.5-6.5</td>
<td>3.5-4.5</td>
<td>2.5-3.5</td>
<td>1.8-2.5</td>
<td>&lt;1.8</td>
</tr>
<tr>
<td>Lease-adjusted MADS (x)</td>
<td>&gt;5.5</td>
<td>3.5-5.5</td>
<td>2.5-3.5</td>
<td>2.0–2.5</td>
<td>1.5-2.0</td>
<td>&lt;1.5</td>
</tr>
</tbody>
</table>

**Qualitative Factors With Positive Impact**
- Revenue dispersion

**Qualitative Factors With Negative Impact**
- MADS Coverage <1x
- MADS Coverage outlier
- Reliant on special funding
- Assessment of '5' or '6' on three or more metrics
# Assessing Liquidity And Financial Flexibility

## Qualitative Factors With Positive Impact
- Extraordinary philanthropy
- No contingent liabilities

## Qualitative Factors With Negative Impact
- Unrestricted reserves < contingent debt
- Days’ cash outlier
- Unrestricted reserves/long-term debt outlier
- Assessment of '5' or '6' on three or more metrics

## Assessment of Liquidity And Financial Flexibility

<table>
<thead>
<tr>
<th>Weighting</th>
<th>Assessment</th>
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<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>15%</td>
<td>Average age of plant (years)</td>
<td>&lt;8.5</td>
<td>8.5–10.0</td>
<td>10.0–11.0</td>
<td>11.0–12.0</td>
<td>12.0–14.0</td>
<td>&gt;14.0</td>
</tr>
<tr>
<td>15%</td>
<td>Capital expenditures/depreciation expense (%)</td>
<td>&gt;175</td>
<td>140–175</td>
<td>120–140</td>
<td>100–120</td>
<td>80-100</td>
<td>&lt;80</td>
</tr>
<tr>
<td>30%</td>
<td>Cash on hand (days)</td>
<td>&gt;275</td>
<td>205-275</td>
<td>160–205</td>
<td>110–160</td>
<td>80-110</td>
<td>&lt;80</td>
</tr>
<tr>
<td>30%</td>
<td>Unrestricted reserves/long-term debt (%)</td>
<td>&gt;225</td>
<td>175-225</td>
<td>120-175</td>
<td>85-120</td>
<td>60-85</td>
<td>&lt;60</td>
</tr>
<tr>
<td>10%</td>
<td>Unrestricted reserves/contingent liabilities (%)</td>
<td>&gt;400</td>
<td>300–400</td>
<td>200-300</td>
<td>100-200</td>
<td>90-100</td>
<td>&lt;90</td>
</tr>
</tbody>
</table>
## Assessing Debt And Contingent Liabilities

<table>
<thead>
<tr>
<th>Assessment</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt burden (%)</td>
<td>&lt;2.2</td>
<td>2.2-2.9</td>
<td>2.9-3.7</td>
<td>3.7-4.8</td>
<td>4.8-5.8</td>
<td>&gt;5.8</td>
</tr>
<tr>
<td>Long-term debt/capitalization (%)</td>
<td>&lt;25%</td>
<td>25–35</td>
<td>35–42</td>
<td>42–50</td>
<td>50–60</td>
<td>&gt;60</td>
</tr>
<tr>
<td>Contingent liabilities/long-term debt (x)</td>
<td>&lt;20%</td>
<td>20–30</td>
<td>30–40</td>
<td>40–50</td>
<td>50–60</td>
<td>&gt;60</td>
</tr>
<tr>
<td>Funded status of defined benefit pension plan (%)</td>
<td>&gt;100</td>
<td>85-100</td>
<td>75–85</td>
<td>65–75</td>
<td>55–65</td>
<td>&lt;55</td>
</tr>
</tbody>
</table>

### Qualitative Factors With Positive Impact
- No contingent liabilities
- No defined-benefit pension plan

### Qualitative Factors With Negative Impact
- Assessment of '5' or '6' on two or more metrics
## Financial Profile – Qualitative Factors

<table>
<thead>
<tr>
<th>Qualitative Factor</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business disruption such as failure to attain accreditation, permanent loss of a</td>
<td>Financial profile assessment may be adjusted negatively by one point</td>
</tr>
<tr>
<td>material payer contract or reimbursement designation, excessive liability, or</td>
<td></td>
</tr>
<tr>
<td>labor issues that threaten operations</td>
<td></td>
</tr>
<tr>
<td>Potentially sizable but as yet unspecified capital plans expected to result in a</td>
<td>Financial profile assessment may be adjusted negatively by one point</td>
</tr>
<tr>
<td>measurable adverse change in debt and/ or unrestricted reserves</td>
<td></td>
</tr>
<tr>
<td>Negative financial policies assessment</td>
<td>Financial profile assessment may be adjusted negatively by one point</td>
</tr>
</tbody>
</table>

Each qualitative factor would change the initial assessment by one point. However, for organizations qualifying for one or more, but not all adjustments, we would generally limit the adjustment to one point, with two points possible in rare circumstances.