



## RATING ACTION COMMENTARY

# Fitch Affirms Covenant Health (DBA Covenant Health System) (MA) Revs at 'BBB'; Outlook Stable

Wed 07 Oct, 2020 - 4:26 PM ET

Fitch Ratings - New York - 07 Oct 2020: Fitch Ratings has affirmed the 'BBB' revenue bond rating on various series of bonds issued by the Massachusetts Development Finance Agency, the Massachusetts Health & Educational Facilities Authority, and the New Hampshire Health & Education Facilities Authority on behalf of the obligated group (OG) of Covenant Health (CH). Fitch also affirms CH's Issuer Default Rating of 'BBB'.

The Rating Outlook is Stable.

## SECURITY

The bonds are secured by a gross revenue pledge of the OG and a mortgage pledge on St. Joseph Hospital in Nashua, NH. The OG includes the parent, Covenant Health, St. Joseph Hospital in Nashua (the only hospital in the OG), and other entities including assisted and skilled nursing facilities. The OG comprised approximately 63% of total assets and 45% of operating revenues of the consolidated system in FY19.

## **ANALYTICAL CONCLUSION**

The affirmation of the 'BBB' rating reflects a financial profile that is consistent with the middle of the 'BBB' category and supported by a strong balance sheet and improved operating performance in FY19. After four straight years of operating losses, CH produced a positive operating margin in FY19. As a result, CH's operating EBITDA margin improved to 5.8% from a negative 3.7% in FY18. The improved performance reflects a largely new management team that is executing on a multifaceted turnaround plan, with results in FY19 exceeding budgeted targets.

FY20 will be a challenging year for CH given the coronavirus pandemic. However, CH began elective surgeries again in June, and management is projecting a better performance for the second half of FY20, with the obligated group (OG) projected to make its debt service covenant. The operating entities outside the OG will likely not meet their debt service coverage covenants but that does not affect the OG debt. CH's solid balance sheet, with cash-to-adjusted debt at 133.4% at June 30, 2020, provides an additional measure of financial flexibility as CH navigates through the pandemic. Fitch's forward-look shows CH's operating EBITDA margin dropping in FY20 but stabilizing in the 5% to 6% range after that. CH has no major capital projects currently planned.

Given the uncertainty created by the pandemic and Fitch's expectation of a slower economic recovery trajectory beginning in 4Q20, CH's operations may experience further volatility than that evidenced in their most recent financial statements for the period ending June 30, 2020. Fitch continues to monitor the severity and duration of the coronavirus and its impact on the sector and the economy, assessing key risks and revising expectations as necessary.

## **KEY RATING DRIVERS**

**Revenue Defensibility: 'bbb'**

Stable Payor Mix and Demographics Offset Secondary Market Position.

A manageable level of Medicaid and self-pay, coupled with service area demographics that are stable, if slightly weaker, supports the midrange revenue defensibility assessment. CH has the second inpatient market share in each of the three markets in New Hampshire and Maine in which it operates. As part of its current strategic plan, CH is focused on strategies aimed at shoring up and growing its current market share.

### **Operating Risk: 'bb'**

Improved Performance in FY19; Limited Capital Needs.

The weak operating risk assessment reflect the expectation that CH's operating EBITDA margins, which have improved from recent levels, will be in the 5% to 6%, consistent with the weak operating assessment. With an EPIC installation completed in FY19, capital spending is expected to remain manageable at the rating level.

### **Financial Profile: 'bbb'**

Good Adjusted Leverage Metrics Offset by Thin Operating Performance.

Fitch's forward-looking analysis shows CH's adjusted leverage metrics remaining consistent with the rating category through economic stress, as operations recover from the pandemic over the next several years.

### **ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS**

No asymmetric risk considerations informed the rating assessment.

### **RATING SENSITIVITIES**

Factors that could, individually or collectively, lead to a positive rating action/upgrade:

--Operating EBITDA margins consistently in the 6% to 8% range, coupled with further balance sheet growth.

Factors that could, individually or collectively, lead to a negative rating action/downgrade:

--A return to negative operating margins, such that operating EBITDA margins remain below 5% over a two- to a three-year period;

--A weakening in unrestricted liquidity or a debt issuance such that cash-to-adjusted debt falls to approximately 120% or below.

## **BEST/WORST CASE RATING SCENARIO**

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [<https://www.fitchratings.com/site/re/10111579>].

## **CREDIT PROFILE**

Covenant Health consists of three acute care hospitals--St. Joseph Hospital in Nashua, NH, St. Joseph Healthcare in Bangor, ME, and St. Mary's Health System in Lewiston, ME--and 10 skilled nursing and assisted living facilities located in the states of Rhode Island, Maine, Massachusetts and Pennsylvania. CH also manages five long-term care facilities, has management relationships with two long-term providers and is affiliated with three other long-term care providers. Fitch's analysis is based on the consolidated system, which had total operating revenue of approximately \$745 million in 2019, but also reviews the financial performance of the OG.

## REVENUE DEFENSIBILITY

CH's combined Medicaid and self-pay represent a manageable 15.7% of gross revenues in FY19, which supports the midrange assessment. The payor mix has been stable over the prior four audited years. CH also has very limited exposure to supplementary governmental funding programs, paying slightly more into provider tax programs than it receives in supplemental funding. The payor mix has remained stable through 1H20.

CH's three acute care hospitals operate in the cities of Bangor and Lewiston in Maine and in Nashua in New Hampshire. CH has the second highest inpatient market share in each of these service areas, with CH's market share approximately 26% to 28% in each of these markets. Its strongest market share is in Nashua, where Southern New Hampshire Medical Center captures about a third of the market. In Bangor and Lewiston, the CH hospitals have about half of the market share of the market leaders, Eastern Maine Medical Center and Central Maine Medical Center, respectively.

The service area characteristics in the three counties where CH has an acute care presence show a stable population and median income and unemployment generally in line or slightly weaker than state and national indicators. For example, the demographically weakest of the counties is Penobscot in Maine, where CH operates St. Joseph Healthcare, a 115 licensed bed facility, in Bangor. In the five-year period ending in 2019, the population growth in Penobscot County was slightly negative, with the population declining approximately 0.7% over this time compared to population growth of 1.0% in Maine and 3.1% in the United States over this same period. The county's median income in 2018 of \$49,374 was lower than the \$55,425 for Maine and \$60,293 for the United States. In contrast, demographics in Hillsborough County, the county for Nashua, were better than the demographics for the state of New Hampshire and the United States.

## OPERATING RISK

After an operating loss of approximately \$61 million in 2018, CH generated positive operating income of \$1.8 million in FY19. The material improvement in performance

reflects a management turnaround plan, as well as the reduction in one-time expenses that went away as the EPIC project was completed. The turnaround plan has been executed under a relatively new management team. Stephen Grubbs started as CEO in April 2019, a new CFO started in September 2019 and other new senior members to the management team, including a new Controller, started in late 2019 and early 2020. The turnaround plan has numerous margin improvement initiatives that includes both efficiency and growth initiatives. In its three acute care markets, CH is focusing on improved access to care, targeted service line growth, additional numbers and types of physicians, including growth in specialists, and the advancement and strengthening of its clinical partnerships. Maximizing the new information technology system is also a component of the overall improvement strategy.

Fitch anticipates that FY20 will be a challenging year. CH lost \$29.9 million through 1H20 and that includes approximately \$28.9 million in federal the Coronavirus Aid, Relief, and Economic Security (CARES) act and other grant funds. With the restarting of elective surgeries in June, CH management reports that volumes are returning, with acuity slightly higher and the payor mix remaining stable. As a result, management is projecting the OG to be able to make its debt service covenant in FY20. Post-pandemic, Fitch expects CH to be able to sustain the improved performance with operating EBITDA margins challenged in 2020 and 2021 but likely stabilizing in the 5% to 6% range after that.

Spending on capital has been extensive in recent years given the EPIC implementation project, with capex averaging approximately 160% of depreciation from FY15 to FY18. CH's age of plant dropped to 14.5 in 2019 from 17.1 years in 2018, with depreciation from the EPIC project helping to bring that figure down. While 14.5 years is still elevated relative to the 'BBB' median of 11.8 years, CH has 11 nursing home and assisted living facilities, which are generally less capital intensive than hospitals and thus carry a higher age of plant. However, an elevated age of plant could indicate capital needs over the longer term for CH to remain competitive. CH reduced its spending on capital in FY19 to approximately 48% of depreciation. Fitch expects capital spending to increase to approximately 75% of depreciation over the next two to four years, with no major capital projects currently planned.

## FINANCIAL PROFILE

CH's financial profile is supported by its strong balance sheet, which supports leverage metrics consistent with the rating. CH's cash-to-adjusted debt was 146.6% in 2019 and net adjusted debt-to-adjusted EBITDA was negative 1.7x, which indicates CH could pay down all its long-term debt in less than one year. CH's days cash on hand was solid at 186.5 days at YE 2019. No debt equivalents were included in the adjusted debt figures, per Fitch's criteria, as CH's frozen defined benefit plan is over 80% funded and its operating leases are capitalized, consistent with the recent changes in accounting board standards.

Through the five-year cycle in Fitch's baseline scenario assumes lower margins in 2020 and a portfolio sensitivity of -17% that is customized to CH's portfolio asset allocation, net adjusted debt-to-adjusted EBITDA remains solidly negative, while cash-to-adjusted debt remains comfortably within the thresholds for a 'BBB' assessment for a hospital with a midrange revenue defensibility and weak operating risk profile. Capital spending figures indicate CH should be able to fund its capital needs over this time. The results demonstrate a measure of resilience at the 'BBB' financial profile assessment with a weak operating risk driver.

### **ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS**

No asymmetric additional risk considerations affected this rating determination. CH has approximately \$250 million in long-term debt (including capitalized leases), of which the vast majority is fixed rate.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

### **REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING**

The principal sources of information used in the analysis are described in the Applicable Criteria.

### **ESG CONSIDERATIONS**

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit

[www.fitchratings.com/esg](http://www.fitchratings.com/esg)

## RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Covenant Health (MA)	LT IDR	BBB Rating Outlook Stable	Affirmed	BBB Rating Outlook Stable
● Covenant Health (MA) /General Revenues/1	LT	BBB Rating Outlook Stable	Affirmed	BBB Rating Outlook Stable

[VIEW ADDITIONAL RATING DETAILS](#)

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## **APPLICABLE CRITERIA**

[U.S. Not-For-Profit Hospitals and Health Systems Rating Criteria \(pub. 27 Nov 2019\)](#)  
(including rating assumption sensitivity)

[Public Sector, Revenue-Supported Entities Rating Criteria \(pub. 27 Mar 2020\)](#) (including rating assumption sensitivity)

## **APPLICABLE MODELS**

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Not-For-Profit Hospitals - Fitch Analytical Stress Test Model, v1.4.2 ([1](#))

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