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Covenant Health System Obligated Group, New Hampshire Massachusetts Development Finance Agency; Hospital

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Long Term Rating	BBB-/Negative	Affirmed

Rating Action

S&P Global Ratings affirmed its 'BBB-' rating on Massachusetts Development Finance Agency's series 2007A revenue bonds and New Hampshire Health & Educational Facilities Authority's series 2007A and B and series 2012 revenue bonds, issued for the Covenant Health System Obligated Group, N.H. The outlook is negative.

Covenant Health Inc. (CH or the system) is the parent organization of the obligated group and all analysis throughout this report is reflective of CH's credit quality overall as reflected in its consolidated audit, including non-obligated entities. The obligated group consists of St. Joseph Hospital in Nashua, N.H.; and several senior living facilities located in Massachusetts and one foundation in Vermont. Several entities outside of the obligated group exist as well, including two acute care providers in Maine and senior living facilities across multiple states. At this time, we consider Covenant Health as a system rather than a stand-alone entity because with recent operating revenue growth, it essentially meets our definition of a health care system as outlined in our health care organization criteria published in March 2018.

Credit overview

The rating reflects CH's positive operating gains in 2019 after several years of negative operating performance, management's and the board's increased focus on generating sustainable positive operating gains, a well-funded defined benefit pension plan, and high unrestricted reserves to long-term debt. Further supporting the rating is CH's multi-state presence along with revenue diversity in long-term care. The rating also incorporates CH's weak operating margins and low maximum annual debt service (MADS) coverage in 2020 as a result of COVID-19 pandemic, as well as high levels of contingent liabilities.

For the six months ended June 30, 2020, the system reported operating losses of $30.6 million, as calculated by S&P Global Ratings, due to the suspension of nonemergent and elective procedures to preserve supplies and prepare for a potential surge in coronavirus cases, as well as additional expenses incurred in response to the pandemic. To offset the losses, CH implemented cost-cutting measures and looked to access state and federal governmental programs to bolster liquidity. To date, CH has received $51.5 million in Medicare advanced payments (which it must repay), as well as $27.9 million in stimulus funds from the Coronavirus Aid Relief and Economic (CARES) Act. CH expects year-end operating losses to be lower than current losses because it expects operational improvements throughout the remainder of the year to be spurred by a recovery in volumes.

The negative year-to-date operating performance overshadows management's recent efforts to return CH to profitability after a difficult 2018, where the system reported a $62 million operating loss largely from an electronic health record (EHR) installation. The 2018 losses brought the obligated group debt service coverage (DSC) to below 1.0x, which constituted a violation of the 1.2x obligated group annual DSC requirement in CH's master trust indenture (MTI) and in its loan agreements with TD Bank N.A. and Siemens. While this covenant violation under the MTI did not constitute an event of default, it did require that CH retain a consultant. Under the TD Bank and Siemens agreements, the noncompliance with the DSC ratio did constitute an event of default, though CH secured a waiver of the DSC requirement deficiency.

The non-obligated group entities St Mary's Regional Medical Center and St Joseph Hospital-Bangor have loans placed with the Maine Health and Higher Education Facilities Authority (MHHEFA), which also requires them to meet a 1.2x DSC ratio. Management does not expect either entity to meet this threshold in fiscal 2020, and is in negotiations with the MHHEFA to secure a waiver. An inability to secure a waiver could lead to the acceleration of approximately $20 million of debt but in our view, CH has ample unrestricted reserves that it should be able to use to repay the debt, if necessary. Management expects the obligated group to be in full compliance with its covenants at fiscal year-end.

The negative outlook reflects CH's inability to consistently generate positive operating positive profits, resulting in weak MADS coverage, and limited headroom under its DSC covenants. While CH's turnaround efforts showed promise in 2019, they were stymied by the COVID-19 pandemic, which set back its turnaround plan. We think that CH's strong balance-sheet metrics support a low investment-grade rating currently, though we believe that persistent operating losses and coverage requirement breaches are not in line with investment-grade ratings.

The 'BBB-' rating reflects our view of CH's:

- Solid balance-sheet metrics that have an important stabilizing impact on the overall financial profile, helping to partially offset persistent operating challenges in the system's acute care operations and acceleration risk;
- Ongoing efforts to reduce its organization-wide cost structure, improve business and clinical processes, and streamline its overall management and governance across the organization; and
- Well-diversified set of long-term providers, geographically dispersed across several states in the northeast.

Partially offsetting the above strengths, in our opinion, are the system's:

- Weak year-to-date operating performance due to the pandemic that is expected to result in a consolidated DSC below 1.0x at fiscal year-end;
- Elevated levels of contingent debt within its overall debt portfolio; and
- Challenging cost structure, although management is focusing in reducing costs and centralizing activities as it moves from a holding company model to an operating model.

Environmental, social, and governance factors

We view social risk as in line with that of peers. The core mission of health care facilities is to protect the health and safety of communities, which is further evidenced by responsibilities to serve the surge in patients ill with the coronavirus. We believe this exposes CH and its peers to additional social risks that could present financial pressure in the short term, particularly should revenues and other federal and state support be insufficient to cover the increased equipment and personnel costs stemming from demand. We believe governance risks are in line with our view of the industry as a whole. While we note CH's recent inability to consistently generate operating profits, we believe that both the management and the board have articulated a path to profitability, as evidenced by the positive 2019 results. Finally, we believe environmental risks are in line with our views of the industry as a whole.

Negative Outlook

Downside scenario

We could lower the rating as soon as our next review if CH is unable to substantially improve its financial performance, increase MADS coverage, and comply with all of its coverage requirements. We could also lower the rating if the balance sheet, which is the key credit factor enabling CH to maintain a low investment-grade rating, diminishes significantly for any reason.

Return to stable scenario

We could revise the outlook to stable if management is able to significantly improve its financial performance in fiscal 2021 with a clear expectation that MADS coverage will be above 1.5x on a consistent basis for the consolidated entity. We would also expect CH to maintain its current balance sheet strength.

Credit Opinion

Enterprise Profile: Adequate

Economic fundamentals and market position

CH's three hospitals are located in separate counties, including Hillsborough County, N.H. (St. Joseph Hospital-Nashua); Androscoggin County, Maine (St. Mary's-Lewiston); and Penobscot County, Maine (St. Joseph Hospital-Bangor). The service area population is approximately 450,000. Hillsborough is the largest county in New Hampshire, with some population and employment growth expected over the next five years, though we note that five-year per capita personal income is above national average. The counties in Maine are projected to face weak-to-negative population growth over the next five years while employment growth is expected to be well below national averages. All three counties are located in more rural service areas, specifically St. Joseph Hospital-Bangor, where the population is sparsely settled.

CH's three hospitals are all situated near a more dominant competitor at each of their respective locations. Despite this level of competition, CH's market share for the past two years has been relatively steady at 17%-18%. The system is also focused on optimizing its clinical relationships. Currently, CH's St. Joseph of Nashua has clinical ties to Lahey

Health and Catholic Medical Center, with a goal of enhancing certain service lines. St. Mary's in Lewiston also has a clinical affiliation with Maine Medical Center. CH is pursuing other relationships throughout the system as opportunities arise, including ties to urgent care providers.

COVID-19 pandemic and response

In accordance with state protocols, CH cancelled or deferred all elective procedures beginning in mid-March. Management worked quickly to prepare itself for the pandemic, and implemented several initiatives, such as creating an incident command center, judiciously managing its personal protective equipment and ventilators through a centralized process, and taking actions to manage cost. However, lower volumes led to a 35% decline in net patient revenue in second-quarter 2020 for its acute-care facilities, and a 15% decline for its post-acute care facilities. Since May, volumes have been progressively returning, though ER volumes are below budget by 14%-20%.

New management team

In the past two years, CH has experienced a turnover in its senior management team. David Lincoln, who had served as President/CEO of CH since its founding in 1986, retired in April 2019. He was replaced by Stephen Grubbs, who had previously joined CH in September 2018 as its interim CFO. In September 2019, Stephen Forney joined the senior management team as CFO; and Don Clark was appointed as controller in December 2019. In 2020, CH also created a number of new positions as it moves toward an operating model of management. Specifically, CH created vice president positions for marketing, strategy, and innovation, and for human resources, both of which have been subsequently filled. In August 2018, Steven Jorgensen was appointed as President to St. Mary's-Lewiston, and John Jurczyk was appointed as President to St. Joseph Hospital-Nashua. We also note a key change on the board with John Olivero becoming board chair in June 2019.

The new leadership team is focused on generating positive systemwide financial and operational stability, as well as enhancing staff accountability for meeting the financial targets. CH's 2019 positive operating results, which the system achieved one year ahead of schedule, suggest that management's initiatives are gaining traction. However, the advent of the COVID-19 pandemic negatively affected CH's ability to further build on 2019 financial performance.

Table 1

Covenant Health Systems, N.H.--Enterprise Statistics

	--Six months ended June 30--	--Fiscal year ended Dec. 31--	
(No.)	2020	2019	2018
PSA population	N.A.	454,967	454,967
PSA market share (%)	N.A.	17.0	18.0
Inpatient admissions	6,706	15,166	14,132
Equivalent inpatient admissions	21,904	51,865	46,909
Emergency visits	29,775	76,240	62,518
Inpatient surgeries	2,960	8,022	3,414
Outpatient surgeries	8,863	24,877	11,709
Medicare case mix index	1.6000	1.6000	1.5000
FTE employees	4,187	4,870	5,006
Active physicians	681	687	712
Top 10 physicians admissions (%)	N.A.	N.A.	23.0

Table 1

Covenant Health Systems, N.H.--Enterprise Statistics (cont.)			
	--Six months ended June 30--	--Fiscal year ended Dec. 31--	
(No.)	**2020**	**2019**	**2018**
Based on net/gross revenues	Gross	Gross	Gross
Medicare (%)	48.0	48.0	40.0
Medicaid (%)	15.0	13.0	9.0
Commercial/Blues (%)	32.0	35.0	31.0

PSA--Primary service area. FTE--Full-time equivalent. N.A.--Not available. Inpatient admissions exclude normal newborn, psychiatric, rehabilitation, and long-term care facility admissions.

Financial Profile: Adequate

All references to unrestricted reserves, long-term debt, and contingent debt exclude Medicare advance payments and other short-term obligations as per S&P Global Ratings' practice. These sources have been considered in our analysis, but are excluded for presentation purposes to maintain year-over-year comparability in metrics. (See the financial table for supplemental data on these excluded items.)

Improved 2019 earnings and cash flow

Fiscal 2018 was a difficult year for CH, and in order to improve operational performance, management worked to implement a number of growth initiatives, right-size its expense base, and operationalize the recommendations of the consultants. Fiscal 2019's operating performance was meaningfully better, in part due to the elimination of EHR headwinds, as well as cost-saving initiatives.

As with most hospitals, CH's recent operational performance to date was negatively affected by the pandemic, which brought about revenue loss from the reduction of nonemergent and elective procedures, as well as additional expenses from preparation efforts for the pandemic. As of June 30, 2020, operating losses, as calculated by S&P Global Ratings were materially higher than $8.3 million operating loss posted for the comparable period in 2019. This loss includes the recognition of approximately $27.8 million in CARES Act relief received through June. Management expects to reduce fiscal 2020 losses to below $20 million, as it expects to benefit from service resumption, additional CARES Act funding, and ongoing cost-cutting efforts. Before the pandemic, management expected fiscal 2020 to generate operating income of $3.1 million.

CH expects MADS coverage at year-end to total approximately 1.0x for the consolidated entity, and 1.5x for the obligated group, thereby avoiding any event of default from the obligated group. We believe that future improvement in MADS coverage will largely depend on any lingering impact from the pandemic and the speed with which volumes return to pre-pandemic levels.

Liquidity and financial flexibility supportive of current rating

We believe that CH's liquidity is sound for a system of its size with both days' cash on hand and unrestricted reserves-to-long term debt in excess of median levels. Average age of plant is high for the rating, and we expect it to remain so, as CH is expected to reduce by half its 2020 capital expenditures to preserve liquidity.

As of June 2020, the investment allocation for CH's unrestricted reserves investment consisted of 42% fixed income, 11% cash, 38% equities, and 9% in alternative investments. Management expects its future asset allocation to be more heavily skewed toward equities.

Elevated levels of direct purchase bank debt

CH's leverage and debt burden as of June 30, 2020, are largely in line with our expectations for the 'BBB-' rating level. Contingent debt as a percentage of total long-term debt is elevated but strong unrestricted reserves-to-contingent liabilities partially offset this risk. The loan agreements include various cure periods but CH has at times has had limited headroom under acceleration triggers. In addition to the required DSC ratio of 1.2x, the agreements with TD Bank and Siemens also require minimum ratings of at least 'BBB-' from all rating agencies rating the obligated group. At this time, management expects the obligated group to meet all covenants in 2020. In 2020, CH refinanced St Mary's and St Joseph Hospital's series 2010B bonds, adding no additional debt to its capital structure.

CH maintains two noncontributory defined benefit pension plans at St. Joseph's-Nashua and St. Joseph's-Bangor. The Nashua plan was frozen in 2007 and the Bangor plan was frozen in 2004. The funding shortfall as of fiscal year-end 2019 was $2.3 million, which we view as very manageable.

Table 2

Covenant Health Systems, N.H.-- Financial Statistics

	--Six months ended June 30--	--Fiscal year ended Dec. 31--	
	2020	**2019**	**2018**
Financial performance			
Net patient revenue ($000s)	292,725	702,555	637,079
Total operating revenue ($000s)	326,928	744,172	664,929
Total operating expenses ($000s)	357,495	743,358	726,904
Operating income ($000s)	(30,567)	814	(61,975)
Operating margin (%)	(9.4)	0.1	(9.3)
Net nonoperating income ($000s)	9,046	21,418	15,171
Excess income ($000s)	(21,521)	22,232	(46,804)
Excess margin (%)	(6.41)	2.90	(6.88)
Operating EBIDA margin (%)	(3.1)	5.7	(3.9)
EBIDA margin (%)	(0.3)	8.4	(1.6)
Net available for debt service ($000s)	(1,006)	64,012	(10,786)
Maximum annual debt service ($000s)	24,916	24,916	24,916
Maximum annual debt service coverage (x)	(0.1)	2.6	(0.4)
Operating lease-adjusted coverage (x)	0.1	2.3	(0.1)
Liquidity and financial flexibility			
Unrestricted reserves ($000s)	367,135	387,545	346,829
Unrestricted days' cash on hand	195.8	198.5	180.8
Unrestricted reserves/total long-term debt (%)	157.0	163.7	142.7
Unrestricted reserves/contingent liabilities (%)	317.4	335.1	288.7
Average age of plant (years)	14.9	14.5	17.1
Capital expenditures/depreciation and amortization (%)	51.9	47.9	216.7

Table 2

Covenant Health Systems, N.H.-- Financial Statistics (cont.)			
	--Six months ended June 30--	--Fiscal year ended Dec. 31--	
	2020	**2019**	**2018**
Debt and liabilities			
Total long-term debt ($000s)	233,790	236,802	243,132
Long-term debt/capitalization (%)	36.8	33.7	37.1
Contingent liabilities ($000s)	115,667	115,667	120,127
Contingent liabilities/total long-term debt (%)	49.5	48.8	49.4
Debt burden (%)	3.7	3.3	3.7
Defined-benefit plan funded status (%)	N.A.	95.4	85.4
Miscellaneous			
Medicare advance payments ($000s)*	51,535	N/A	N/A
Short-term borrowings ($000s)*	0	0	0
Total net special funding ($000s)	(6,395)	(13,906)	(14,365)

*Excluded from unrestricted reserves, long-term debt, and contingent liabilities. N/A--Not applicable. N.A.--Not available. MNR--Median not reported.

Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Credit Snapshot

- Organizational overview: CH sponsors, is affiliated with, or manages 20 organizations, primarily in New England. CH, the parent, is financially responsible for sponsored and member facilities, which currently include three hospitals, nine skilled nursing facilities, and six housing/assisted living organizations, in addition to a captive insurance company, a real estate holding company, and a foundation. Managed and affiliated entities pay CH a fee, depending on the types of services it provides. The obligated group consists of St. Joseph Hospital in Nashua, N.H.; several senior living facilities located in Massachusetts; and one foundation in Vermont. Several entities outside of the obligated group also exist, including two acute care providers in Maine and two other senior living facilities across multiple states.
- Group rating methodology: In our view, the obligated group is core to the group credit profile of CH because of the integral nature of St. Joseph Hospital, Nashua to the enterprise overall and as an original member.
- Security: A gross revenue pledge of the obligated group secures the bonds

Ratings Detail (As Of September 18, 2020)

Massachusetts Development Finance Agency, Massachusetts

Covenant Hlth Sys Obligated Grp, New Hampshire

Massachusetts Dev Fin Agcy (Covenant Health Sys Obligated Group)

Ratings Detail (As Of September 18, 2020) (cont.)		
Long Term Rating	BBB-/Negative	Affirmed
Massachusetts Dev Fin Agy (Covenant Health System Obligated Group)		
Long Term Rating	BBB-/Negative	Affirmed