FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Covenant Health's (MA) Ser 2023 Revs 'BBB'; Affirms 'BBB' IDR; Outlook Remains Negative

Tue 11 Jul, 2023 - 3:11 PM ET

Fitch Ratings - New York - 11 Jul 2023: Fitch Ratings has assigned a 'BBB' rating to the following bonds issued on behalf of Covenant Health (CH, d/b/a Covenant Health System):

--$33,460,000 Maine Health and Higher Educational Facilities Authority Revenue Bonds, Covenant Health Obligated Group Issue, Series 2023;

--$56,060,000 New Hampshire Health and Education Facilities Authority Revenue Bonds, Covenant Health Obligated Group Issue, Series 2023.

Fitch has also affirmed CH's Issuer Default Rating (IDR) at 'BBB' and the 'BBB' rating on Series 2021-1 and Series 2021-2 notices issued by CH.

The 2023 bonds were issued as fixed-rate tax-exempt bonds and were privately placed in March 2023. Bond proceeds refinanced about $90 million of CH's taxable debt.

The Rating Outlook remains Negative.

RATING ACTIONS

ENTITY / DEBT	RATING		PRIOR
Covenant Health (MA)	LT IDR Affirmed	BBB Rating Outlook Negative	BBB Rating Outlook Negative

Covenant Health (MA) /General Revenues/1 LT	LT	BBB Rating Outlook Negative Affirmed	BBB Rating Outlook Negative

VIEW ADDITIONAL RATING DETAILS

The affirmation of the 'BBB' rating reflects CH's much-improved operating performance in Q1 2023, a solid balance sheet for the rating (cash to adjusted debt was about 136% at March 31), and a light debt burden, measured by maximum annual debt service (MADS) of $15.3 million, equating to a modest 1.9% of FY22 revenues. CH lost $8.9 million in 1Q23, which is a significant improvement over the $23.2 million operating loss in 1Q22. The yoy improvement reflects an increase in most patient volumes and the initial positive effects of a $124 million turnaround plan. Fitch views CH's turnaround plan, which was formulated with the assistance of a consultant, as comprehensive and reasonable.

The maintenance of the Negative Outlook reflects the execution risk associated with the turnaround plan, operational results that while improved are still negative, and healthcare sector headwinds related to staffing, especially for nurses, and inflationary pressures. After losing $87 million in 2022, CH is budgeting for a $14 million loss in 2023. Should CH make its budget, not violate its 1.2x debt service covenant in 2023, and continue to improve its operational performance through 2024, the Outlook would likely move to Stable. A return to sizable operating losses would lead to a downgrade.

SECURITY

The bonds and notes are secured by a gross receivables pledge from all obligated group members, which includes the three acute care hospitals, and mortgages on the three acute care hospitals.

KEY RATING DRIVERS

Revenue Defensibility - 'bbb'

Stable Payor Mix and Demographics Offset Secondary Market Position

The midrange revenue defensibility is supported by a manageable level of combined Medicaid and self-pay (16.6% at March 31, 2023) and service area demographics that are stable. These offset CH's somewhat weaker market position. CH operates three acute care hospitals in the cities of Bangor and Lewiston in Maine, and in Nashua in New Hampshire. CH trails the market leaders in each of its markets, with the market share approximately

14% to 30% in the individual markets. CH is focused on strategies aimed at shoring up and growing its market share.

The service area characteristics in the three counties where CH has an acute care presence show a stable population and median income and unemployment levels generally in line with or slightly weaker than state and national indicators. The demographics are reflected in the payor mix, which has been stable over the prior four audited years. CH has limited exposure to supplementary governmental funding programs, paying slightly more into provider tax programs than it receives in supplemental funding.

Operating Risk - 'bb'

Period of Operating Stress; Limited Capital Needs

The weak operating risk assessment reflects operating EBITDA margins that have been below 5% since 2019. In 2022, CH operating performance deteriorated further due to revenue and expense pressures. CH lost $87.5 million in 2022 and violated a debt service coverage covenant. In response, CH embarked on a turnaround plan that included a consult engagement. Additionally, CH management identified a few other areas for improvement outside the consultant's recommendations.

The turnaround plan touches all of CH's system components, including central corporate administration, acute care, and skilled nursing, and identifies savings, efficiencies, and revenue opportunities across the system and within each market. Fitch reviewed the action plan and views it as reasonable. Fitch also notes that while Q1 2023 results showed improvement, those results reflect only a small portion of the expected positive effects of the turnaround plan, given implementation started in January 2023.

The weaker operating risk assessment is also reflected in CH's capex. CH has a slightly elevated age of plant of 15.6 years at YE22 and capital spending has been below depreciation expense in the last four years (after an EPIC installation project that ended in 2018). Capex is expected to remain below depreciation over the next two to three years. However, Fitch believes CH is investing enough in its hospitals for them to remain competitive.

Financial Profile - 'bbb'

Leverage Metrics Resilient Through a Moderate Stress Scenario

CH's financial profile is supported by its balance sheet, with CH's cash-to-adjusted debt at about 129% at YE22. CH's days cash on hand was adequate at approximately 135 days at YE22. 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.

Fitch's forward look assumes a slightly positive operating EBITDA margin in 2023, and then operating EBITDA margins continue to improve stabilizing to levels closer to 5% in the out years. Base case results show CH's adjusted leverage metrics remaining consistent with the 'bbb' financial profile assessment thresholds. In the stress case, CH's key leverage metrics show strain in the next two to three years, indicating limited near-term financial flexibility, but the metrics reach levels consistent with a 'bbb' financial profile in the latter years.

Asymmetric Additional Risk Considerations

There are no asymmetric risks associated with the rating.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Failure to produce 1x coverage in 2023, which would be an event of default;

--A weakening in unrestricted liquidity or a debt issuance such that cash-to-adjusted debt falls to below 120% and is expected to stabilize at the lower level;

--Starting in 2024, an inability to improve the operating performance, such that operating EBITDA margins remain materially below 5% over a two- to three-year period.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--A revision of the Outlook to Stable would be predicated on CH not violating a debt service coverage covenant in 2023, further improvement to the operating performance in 2024, and cash flow levels that grow CH's balance sheet;

--Longer term, operating EBITDA margins consistently in the 6% to 8% range, coupled with further balance sheet growth, could lead to a higher rating.

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.

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. It also consists of 10 skilled nursing and assisted living facilities located in the states of Rhode Island, Maine, Massachusetts, and Pennsylvania. In addition, CH 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 revenues of nearly $790 million in 2022.

Sources of Information

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.

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APPLICABLE CRITERIA

U.S. Not-For-Profit Hospitals and Health Systems Rating Criteria (pub. 18 Nov 2020) (including rating assumption sensitivity)

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 27 Apr 2023) (including rating assumption sensitivity)

APPLICABLE MODELS

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

Portfolio Analysis Model (PAM), v2.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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