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Covenant Health Inc., Massachusetts; Hospital; System

Primary Credit Analyst:
Marc Bertrand, Chicago + 1 (312) 233 7116; marc.bertrand@spglobal.com

Secondary Contact:
Blake C Fundingsland, Englewood + 1 (303) 721 4703; blake.fundingsland@spglobal.com

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Credit Profile		
US$56.06 mil rev bnds (Covenant Health Obligated Group) ser 2023 dtd 07/21/2023 due 07/01/2037		
Long Term Rating	BBB-/Stable	New
US$33.46 mil rev bnds (Covenant Health Obligated Group) ser 2023 dtd 07/14/2023 due 07/01/2037		
Long Term Rating	BBB-/Stable	New

Credit Highlights

- S&P Global Ratings assigned its 'BBB-' long-term rating to Maine Health & Higher Educational Facilities Authority's tax-exempt series 2023 bonds (par amount $33.46 million) and to New Hampshire Health and Education Facilities Authority's tax-exempt series 2023 bonds (paramount $56.06 million), issued for Covenant Health Obligated Group, Mass.
- At the same time, S&P Global Ratings affirmed its 'BBB-' long-term rating on the series 2021-1 and 2021-2 notes issued by Covenant Health Inc. (Covenant Health), as well as its 'BBB-' issuer credit rating (ICR) on Covenant Health.
- The outlook is stable.
- Covenant Health is the parent organization of the obligated group and all analysis throughout this report is reflective of Covenant Health's credit quality overall, including non-obligated entities.

Security

The proceed of the series 2023 bonds, which were issued in March 2023, were used to refund a portion of the series 2021-2 notes as well as pay certain costs associated with the issuance.

The debt outstanding is secured by a gross receivables pledge from the obligated group consisting of St. Joseph Hospital in Nashua, N.H.; St. Mary's Regional Medical Center in Lewiston, Maine; St. Joseph Hospital in Bangor, Maine; and several senior-living facilities in Massachusetts. The debt is further secured by mortgages on the hospitals.

The ICR reflects the overall creditworthiness of the issuer and is not assigned to a specific debt instrument.

Credit overview

The rating reflects the strength of Covenant Health's balance sheet, including good days' cash on hand and leverage, which remains supportive of the rating despite the recent weakening from accelerated and unanticipated losses in fiscal 2022. The rating also reflects the system's ongoing turnaround efforts, which are expected to yield a significant reduction in operating losses for fiscal 2023.

The rating incorporates Covenant Health's solid but not leading market position in the three main markets for its acute-care hospitals where the system is second to well-established competitors, along with a senior living portfolio (17% of total operating revenue in 2022) that has been hit particularly hard by labor and volume challenges and has been slow to recover. Covenant Health's acute-care facilities are typically not market leaders in their communities; however, the diversity and synergies between senior living and acute care, as well as Covenant Health's location in multiple states, have supported some revenue diversity. We do not expect meaningful changes to the enterprise profile over the outlook period, as the proposed affiliation agreement with Day Kimball Healthcare (in Connecticut) was terminated in March 2023.

Similar to most health care providers, Covenant Health experienced operating headwinds in fiscal years 2022, including rising labor costs, staffing challenges, and fluctuating volumes. As a result, the system reported significant operating losses that, along with weaker non-operating income, led to a violation of its 1.1x rate covenant, with management proactively hiring consultants as required. Management expects to meaningfully reduce operating losses in fiscal 2023, due to an abatement in agency costs and improving volumes. In addition, Covenant Health also expect to benefit from its turnaround initiatives that center on corporate expense management, revenue cycle, its integrated medical group, case management and coordination, service line optimization, and post-acute case operations. To date, management reports interim March 2023 reduced year-over-year operating losses that are favorable to the current budget, while several one-time initiatives and additional expense management efforts represent potential upside for the year. The inability of management to materially improve operating performance to near budgeted targets in fiscal 2023 ($14 million operation loss) and maintain debt service above 1.1x would likely result in a negative outlook at the next review. We note that failure to attain 1.0x coverage in fiscal 2023 would trigger an event of default, although management expects to meet its debt service covenant for fiscal 2023.

The 'BBB-' rating reflects our view of Covenant Health's:

- Solid, although weaker, balance-sheet metrics that still compare favorably with rating level medians;
- Efforts well underway, with partnership and consultant assistance, to improve operating performance;
- Well-diversified set of long-term and acute-care providers, geographically dispersed across several states in the northeast; and
- Conservative balance sheet, with a recently simplified debt structure that lowered debt service to improve coverage, along with a well-funded pension plan.

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

- Uneven operating performance in recent years, with a significantly higher operating loss in fiscal 2022, primarily as a result of labor cost escalation and softer-than-expected volume, with the expectation of continued losses in 2023, albeit at a lower level;
- Recent debt coverage violation, although it was not an event of default, with maximum annual debt service (MADS) coverage expected to improve management implements its turnaround plan; and
- Location in competitive markets, with declining market share at all three hospitals.

Environmental, social, and governance

We view social risk as neutral to the credit rating analysis. That said, Covenant Health is experiencing additional human capital social risks tied to higher labor and salary pressures that began in late 2021 and are likely to continue through 2023, although some abatement is expected as the year progresses. We view environmental and governance risks as neutral to our credit rating analysis.

Outlook

The stable outlook assumes material headway toward improved earnings, as well as an ability to meet all covenants, including debt service coverage, for fiscal 2023. Supporting the rating during this period is Covenant Health's balance sheet that, although weaker, remains solid for the rating level with no material changes anticipated as management has constrained capital spending. The outlook also assumes no material changes to Covenant Health's enterprise profile.

Downside scenario

We could revise the outlook to negative or lower the rating to speculative-grade if Covenant Health is unable to make material improvement in its operating performance sufficient to generate above 1.1x debt service coverage, or if the organization's balance-sheet cushion further erodes.

Upside scenario

We do not believe the rating or outlook has any upside potential during the outlook period, given Covenant Health's recently weak operating performance, including a three-year trend of operating losses, and diminished balance-sheet cushion. However, a favorable action could be considered over time with a trend of positive operations that we view as sustainable, along with incremental balance-sheet improvement and a stable enterprise profile.

Credit Opinion

Enterprise Profile: Adequate

Economic fundamentals of Covenant's main markets

Covenant Health's three hospitals are in Hillsborough County, N.H. (St. Joseph Hospital--Nashua); Androscoggin County, Maine (St. Mary's Health System--Lewiston); and Penobscot County, Maine (St. Joseph Hospital--Bangor). The service area populations total slightly more than 460,000. Hillsborough is the largest county in New Hampshire, and in contrast to the more rural Maine service areas, is displaying high per capita personal income growth, although population and employment growth remain below national averages. The counties in Maine are projected to face limited-to-negative population and employment growth. All three counties are located in more rural service areas, specifically St. Joseph Hospital--Bangor, where the population is sparsely settled.

Solid, albeit not leading, market position modestly declining in 2022

Covenant Health's hospitals are all situated near a more dominant competitor at each of their respective locations, and market share has slightly declined over the past year. Nevertheless, market share remains meaningful, ranging from 18% in Bangor to 28% in Nashua and 30% in Lewiston.

The system has clinical relationships with several larger systems in New Hampshire, Massachusetts, and Maine, as well as ownership of long-term care assets both near acute-care operations as well as in other stand-alone locations. In total, Covenant Health operates 12 post-acute care facilities in five states, including the January 2022 acquisition of Bangor Nursing and Rehabilitation Center (near St. Joseph Hospital in Maine.

Day Kimball Healthcare affiliation agreement terminated

On March 10, 2023, Covenant Health announced that it had terminated its affiliation agreement with Day Kimball Healthcare. Covenant cited new and updated information as part of its due diligence process as the key driver of the decision. The potential merger, which would have allowed Covenant Health to expand its presence in Connecticut, was not expected to materially alter affect Covenant Health's credit profile, given Day Kimball Healthcare's smaller size and limited debt outstanding, although some dilution to days' cash on hand (DCOH) was expected.

Table 1

Covenant Health Systems, Massachusetts -- enterprise statistics				
	--Three months ended March 31--	--Fiscal year ended Dec. 31--		
	2023	2022	2021	2020
PSA population	N.A.	463,082	463,082	457,749
PSA market share (%)	N.A.	N.A.	N.A.	N.A.
Inpatient admissions	3,043	12,570	13,029	12,433
Equivalent inpatient admissions	10,868	43,345	48,468	44,137
Emergency visits	18,355	77,202	71,594	61,516
Inpatient surgeries	480	1,078	940	2,360
Outpatient surgeries	2,115	5,816	3,326	7,069
Medicare case mix index	1.5500	1.5500	1.6200	1.5700
FTE employees	4,565	4,544	4,606	4,271
Active physicians	1,509	1,505	1,457	1,304
Based on net/gross revenues	Gross	Gross	Gross	Gross
Medicare (%)	41.0	35.4	34.8	47.3
Medicaid (%)	14.8	15.9	15.4	15.4
Commercial/Blues (%)	42.4	48.4	49.6	34.3

N.A.--Not available. Inpatient admissions exclude normal newborn, psychiatric, rehabilitation, and long-term care facility admissions.

Financial Profile: Adequate

Meaningful operating losses in 2022 along with covenant violation

Covenant Health's operating performance meaningfully deteriorated in fiscal 2022, due in large part to labor and wage pressures, including salary adjustments and high agency costs. Inflationary pressures, softer volumes driven in part by service curtailment from staffing shortages, and throughput issues also contributed to the weaker performance, with some offset from the recognition of $1.6 million in CARES Act or other governmental relief funds, which was meaningfully lower than the previous year ($29.4 million).

Operating losses accompanied by weaker non-operating income led Covenant Health to violate its 1.1x debt service covenant in fiscal 2022. The breach of covenant required a consultant call-in, which management had proactively sourced before year-end. The consultants developed a comprehensive turnaround plan designed to meaningfully improve operating performance between $83.3 million and $127.3 million at the high end, with a meaningful portion expected to be realized in fiscal 2023. Management has also outlined further areas of improvement where it expects additional savings can be generated over the outlook period. Management expects to generate debt service coverage above 1.1x for fiscal 2023.

Year to date through the three months ended March 31, 2023, Covenant Health has generated operating losses, which are lower year-over-year due to the abatement of labor costs at its hospitals, although issues at the skilled nursing facilities have been slightly more persistent. With the benefit of the turnaround initiatives and outsourcing, Covenant Health expects operating performance to progressively improve throughout the year, and has budgeted for a much more modest operating loss in fiscal 2023 with current performance favorable to budget. Despite the protracted labor and volume issues, the budget seems achievable given year-to-date results, and has several one-time items that are not included in the current budget that could allow the system to meet or exceed current expectations.

Unrestricted reserves provide rating stability, but are dwindling

Covenant Health's unrestricted reserves significantly diminished as of March 2023 compared with fiscal 2022 year-end due to market volatility and operating losses; however, they remain above expectations for the 'BBB-' rating relative to operating expenses and debt outstanding. We believe this provides Covenant Health with some flexibility to manage through this period of heightened operating losses; however, continued deterioration in these metrics could result in a negative outlook or downgrade, especially if implementation of the improvement plan is slower than expected, resulting in thin cash flow.

Management has conserved on capital, with consistent spending well under depreciation expense since 2019, resulting in an escalating average age of plant. Management has budgeted for capital spending of $12.6 million in fiscal 2023 (50% of depreciation expense) to conserve reserves. Capital spending is largely focused on replacement equipment at the three hospitals as well as on information technology. Management is in the process of a master facility plan, so we will likely have more insight into future capital needs at the next review.

Conservative balance-sheet characteristic remains supportive of the rating

We view Covenant Health's debt profile as a credit strength, with long-term debt-to-capitalization and a debt burden that remain favorable to rating medians. In September 2021, Covenant Health simplified its debt structure by issuing series 2021-1 and 2021-2 bonds to refund all long-term debt issued by the obligated group under a unified structure that yielded $6 million less of debt service payments (interest only through 2026). Covenant subsequently replaced $92.0 million of the taxable series 2021-1 with $89.5 million of the lower coupon tax-exempt series 2023, allowing for a reduction in total principal and interest payments.

Covenant Health maintains a noncontributory defined-benefit pension plans at St. Joseph's--Nashua, having recently terminated the plan at Bangor. The plan is very well-funded, which we view positively, as resources can be directed toward strategic capital and operating initiatives instead of pension payments.

Table 2

Covenant Health Systems, Massachusetts -- financial statistics					
	--Three months ended March 31--	--Fiscal year ended Dec. 31--			Medians for 'BBB-' rated healthcare systems
	2023	2022	2021	2020	2021
Financial performance					
Net patient revenue ($000s)	199,459	737,075	722,328	618,685	3,233,651
Total operating revenue ($000s)	209,429	788,628	783,912	718,735	4,230,599
Total operating expenses ($000s)	218,286	876,151	794,216	724,832	4,392,184
Operating income ($000s)	(8,857)	(87,523)	(10,304)	(6,097)	(127,347)
Operating margin (%)	(4.23)	(11.10)	(1.31)	(0.85)	(1.40)
Net nonoperating income ($000s)	(1,204)	3,492	67,578	14,521	45,374
Excess income ($000s)	(10,061)	(84,031)	57,274	8,424	(73,023)
Excess margin (%)	(4.83)	(10.61)	6.73	1.15	(0.40)
EBIDA margin (%)	(0.24)	(5.97)	10.83	6.63	5.00
Net available for debt service ($000s)	(507)	(47,280)	92,225	48,623	116,968
Maximum annual debt service ($000s)	16,324	16,324	16,324	16,324	90,769
Maximum annual debt service coverage (x)	(0.12)	(2.90)	5.65	2.98	1.50
Operating lease-adjusted coverage (x)	(0.03)	(2.64)	5.30	2.42	1.40
Liquidity and financial flexibility					
Unrestricted reserves ($000s)	329,086	323,078	433,876	394,538	1,243,773
Unrestricted days' cash on hand	142.2	138.9	206.0	207.3	104.3
Unrestricted reserves/total long-term debt (%)	148.2	139.7	184.9	183.8	89.6
Unrestricted reserves/contingent liabilities (%)	N/A	N/A	N/A	530.1	837.8
Average age of plant (years)	14.9	15.6	15.6	14.4	11.5
Capital expenditures/depreciation and amortization (%)	61.4	65.9	94.8	74.0	164.4
Debt and liabilities					
Total long-term debt ($000s)	222,008	231,342	234,612	214,606	1,452,435
Long-term debt/capitalization (%)	36.9	39.0	31.9	31.1	53.2
Contingent liabilities ($000s)	89,520	0	0	74,421	290,761
Contingent liabilities/total long-term debt (%)	40.3	0.0	0.0	34.7	14.0
Debt burden (%)	1.96	2.06	1.92	2.23	2.10
Defined benefit plan funded status (%)	N.A.	96.41	99.90	100.10	85.50
Miscellaneous					
Medicare advance payments ($000s)*	0	0	35,200	52,300	MNR
Short-term borrowings ($000s)*	0	0	0	0	MNR
CARES Act grants recognized ($000s)	0	1,600	24,900	63,100	MNR
Risk based capital ratio (%)	N/A	N/A	N/A	N/A	MNR
Total net special funding ($000s)	(812)	(5,548)	(5,433)	(3,628)	MNR

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

Credit Snapshot

- Group rating methodology: Core.
- Organization description: Covenant Health sponsors, is affiliated with, or manages, three acute-care and 12 long-term skilled- and assisted-care facilities, primarily in New England (Maine, New Hampshire, Massachusetts, and Rhode Island). Covenant Health, the parent, is financially responsible for sponsored and member facilities in addition to a captive insurance company, a real estate holding company, and a foundation. Covenant Health is the parent organization of the obligated group and all analysis throughout this report is reflective of Covenant Health's credit overall quality, based on the system's consolidated audit, including nonobligated entities.

Related Research

- Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022

Ratings Detail (As Of July 11, 2023)		
Covenant Health, Inc. ser 2021-2 nts due 07/01/2051		
Long Term Rating	BBB-/Stable	Affirmed
Covenant Health, Inc. ICR		
Long Term Rating	BBB-/Stable	Affirmed
Covenant Health, Inc. 2021-1 nts ser 2021-1 due 07/01/2041		
Long Term Rating	BBB-/Stable	Affirmed

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