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Massachusetts Development Finance Agency
New Hampshire Health and Educational Facilities Authority
Covenant Health System Obligated Group; Hospital

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Massachusetts Development Finance Agency, Massachusetts		
Covenant Hlth Sys Obligated Grp, New Hampshire		
Series 2007A&B		
Long Term Rating	BBB-/Negative	Downgraded, Removed from CreditWatch
Series 2012		
Long Term Rating	BBB-/Negative	Downgraded, Removed from CreditWatch
New Hampshire Hlth & Ed Facs Auth, New Hampshire		
Covenant Hlth Sys Obligated Grp, New Hampshire		
Series 2002, 2004, 2007A&B 2012		
Long Term Rating	BBB-/Negative	Downgraded, Removed from CreditWatch

Rationale

S&P Global Ratings lowered its rating on Massachusetts Development Finance Agency's series 2007A revenue bonds and New Hampshire Health & Educational Facilities Authority's series 2007A&B and series 2012 revenue bonds issued for the Covenant Health System Obligated Group, N.H. to 'BBB-' from 'BBB', and removed the rating from CreditWatch, where it had been placed with negative implications on Feb. 15, 2019. The outlook is negative.

Covenant Health Inc. (CH) 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 two other senior living facilities across multiple states.

The downgrade and negative outlook reflect CH's substantial operating loss of negative $62 million (negative 9.3%) in fiscal year ended Dec. 31, 2018, in part, driven by an electronic medical record (EMR) installation that brought both consolidated and obligated group debt service coverage to less than 1x, and balance sheet weakening. The losses in fiscal 2018 and inadequate debt service coverage constituted a violation of the 1.2x obligated group annual debt service coverage requirement in CH's master trust indenture (MTI) as well as in its loan agreements with TD Bank N.A. and Siemens. Under the MTI, noncompliance with the debt service coverage requirement does not constitute an event of default, but it does require CH to retain a consultant to make recommendations to increase the debt service coverage ratio. CH has engaged with the consultant, and the consultant finalized its report and recommendations at the end of May 2019. While the details of the consultant's report are confidential, at a high level, the recommendations center on expense reductions, particularly around administrative corporate costs, and it applied to all of CH (not just the obligated group). Under the TD Bank and Siemens agreements, noncompliance with the debt service coverage ratio constitutes an event of default and could result in an acceleration of the debt if the deficiency is not waived. Positively, CH has secured a waiver of the debt service coverage requirement deficiency from both TD Bank and Siemens. As part of the waiver, CH has agreed to quarterly testing of debt service coverage compliance. It's our understanding from management that if CH fails this quarterly test, another consultant review (not acceleration) would be triggered.

The non-obligated group entities have approximately $22 million of debt placed with the Maine Health and Higher Education Facilities Authority (MHHEFA), the agreements for which also require a 1.2x debt service coverage ratio of those entities that was also breached in fiscal 2018. It is our understanding that management in negotiations with MHHEFA to secure a waiver, but has not yet done so, leaving approximately $22 million of CH debt that could be accelerated. In our view, CH's unrestricted reserves, which totaled $354 million at the end of first-quarter fiscal 2019 equating to 188 days' cash on hand and 1.5x long-term debt, would be strong enough (despite the sizable fiscal 2018 reduction) to withstand a $22 million acceleration and still be a stabilizing factor in the overall financial profile. However, according to management, in order to access the $354 million to pay off this debt, the obligated group needs to be in compliance with its debt service requirements.

While the sound balance sheet metrics are key to partially offsetting CH's operating losses and help support the low investment-grade rating, the persistence and severity of CH's operating losses, and the potential for debt acceleration, are more consistent with a speculative-grade rating, in our view. Fiscal 2018 marked CH's fifth consecutive worse-than-budgeted operating loss, and for fiscal 2019 CH has adopted a budget that calls for a smaller but still substantial operating loss of $23 million (negative 3%). CH's new CEO and interim CFO (appointed in 2019) bring a renewed focus to realizing sustainable financial improvement, which gives some reason for optimism. However, we believe the fiscal 2019 budget is somewhat optimistic and will be difficult to achieve, and that laying the groundwork for a sustainable financial turnaround will be a multiyear effort.

We continue to assess CH's enterprise profile as adequate, characterized by stable market share for each of its hospitals despite meaningful competition in each market, and consistently high occupancy at its senior living and nursing facilities. CH does not have any swap exposure.

The rating and negative outlook further reflect our view of CH's:

- Challenging cost structure, with very high administrative overhead costs persisting as management aims to move from a holding company model to an operating model, and an expense base that has grown at 3x the rate of revenue in the past couple of years; and
- Elevated levels of contingent debt (i.e. direct purchase instruments placed with third parties are 50% of total debt)

within its overall debt portfolio as CH's contingent debt carries acceleration risk, with more requirement triggers than in its traditional bond documents, some of which include a minimum rating requirement of 'BBB-'.

Precluding a lower rating are CH's:

- Stable inpatient market share of about 27%-29% in each of its three hospital markets, although there is a dominant competitor in each market, combined with a diversified set of long-term providers, geographically dispersed across several states in the northeast; and
- Solid balance sheet metrics that have an important stabilizing impact on the overall financial profile, helping to partially offset persistent operating challenges in its acute care operations and acceleration risk.

Outlook

The negative outlook reflects our view of CH's deep, structural operating challenges that we think could persist throughout the two-year outlook period as the new management team works on implementing its turnaround plan, which we think will take time to fully operationalize. While CH's strong balance sheet metrics support a low investment-grade rating currently, the continued and persistent operating losses and coverage requirement breach are more consistent with a speculative-grade rating.

Downside scenario

We could lower the rating as soon as our next review if CH is unable to substantially improve financial performance as forecast 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 its low investment-grade rating, diminishes significantly for any reason.

Upside scenario

We could revise the outlook to stable if management is able to significantly improve its financial performance in fiscal 2019 and fiscal 2020, with a clear expectation that MADS coverage will be above 1.5x on a consistent basis for the organization as whole. We would also expect CH to maintain its current balance sheet strength. A higher rating is unlikely throughout the outlook period unless the organization can achieve consistent positive operating margins.

Enterprise Profile: Adequate

Economic fundamentals

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). Hillsborough is the largest county, with some limited population and employment growth expected over the next five years. The service area population is approximately 450,000. The counties in Maine are projected to face slightly declining population over the next five years with limited employment growth that is well below national averages. All three of these counties are located in more rural service areas, specifically St. Joseph Hospital-Bangor, where the population is sparsely settled.

Market position

CH's three hospitals are all situated near a more dominant competitor at each of its respective locations. Despite this level of competition, CH's market share has held steady at 29%. However, inpatient and outpatient utilization declined in fiscal 2018 by 4% overall primarily due to the loss of employed physicians. Through the first quarter of fiscal 2019, inpatient volume at St. Joseph Hospital-Nashua is down 7% from the same point last year, while inpatient volumes at St. Mary's-Lewiston and St. Joseph Hospital-Bangor are up 4% and 6%, respectively. Occupancy remains high at the majority of CH long-term-care providers, hovering at or greater than 90% in most locations. Volume growth is one of management's key strategic priorities, and in fiscal 2018 CH added over 50 new primary care and specialty providers to the employed network and has a 2019 target to add 34 more to bolster volumes.

CH is also focused on optimizing its clinical relationships. It currently has clinical ties to Lahey Health and Catholic Medical Center systems at its St. Joseph Hospital of Nashua, 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.

New management team

David Lincoln, who had served as President/CEO of CH since its founding in 1986, retired in April 2019 and was replaced by Stephen Grubbs. Mr. Grubbs joined CH in September 2018 as the interim CFO. Robert Tarola is currently serving as CH's interim CFO. In addition, 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. The new leadership team is focused on regaining systemwide financial and operational stability and enhanced systemwide accessibility and transparency around financial targets and progress.

In our view, the new leadership team and its renewed focus on achieving a sustainable financial turnaround is positive, but it will take time to fully operationalize necessary changes across the organization.

Table 1

Covenant Health Systems, Mass. -- Enterprise Statistics			
	--Three months ended March 31--	--Fiscal year ended Dec. 31--	
	2019	2018	2017
Primary service area (PSA) population	N.A.	N.A.	442,754
PSA market share (%)	N.A.	N.A.	28.0
Inpatient admissions	3,265	12,765	13,295
Equivalent inpatient admissions	11,089	43,164	46,060
Emergency visits	16,788	67,516	69,433
Inpatient surgeries	804	3,320	3,316
Outpatient surgeries	1,934	8,423	9,229
Medicare case mix index	1.5200	1.4900	1.5000
Full-time equivalent employees	4,953	5,006	4,990
Active physicians	699	695	714
Top 10 physicians admissions (%)	N/A	N/A	N/A
Based on net/gross revenues	Gross	Gross	Gross
Medicare (%)	48.2	48.0	45.1

Table 1

Covenant Health Systems, Mass. -- Enterprise Statistics (cont.)			
	--Three months ended March 31--	--Fiscal year ended Dec. 31--	
	2019	2018	2017
Medicaid (%)	11.7	10.1	10.5
Commercial/Blues (%)	32.7	34.3	34.7

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

Financial Profile: Adequate

Highly vulnerable financial performance

Fiscal year ended Dec. 31, 2018 marked CH's fifth consecutive annual operating loss. The 2018 operating loss of $62 million, or negative 9.3% (closing unfavorably to the $35 million loss budgeted) reflected significant EMR implementation costs, as well as other issues including heavy use of temporary labor and new permanently higher IT costs. Management also noted the transition of two hospital presidents in 2018 as a reason for greater-than-anticipated operating losses. For fiscal 2019, management has adopted an operating budget calling for an operating loss of $23 million (negative 3.2% operating margin). Achieving the fiscal 2019 budget depends on revenue assumptions including 7% growth in acute services, 4% growth in post-acute services, and 14% growth in the integrated medical group, and expense assumptions centered on reducing locum and agency costs. In our view, these growth assumptions are somewhat optimistic, and we think a fiscal 2019 operating budget shortfall could occur as management continues to work through implementing its growth initiatives, rightsizing its expense base, and operationalizing the recommendations of the consultant. CH is outperforming budget through the first quarter of fiscal 2019, closing the first quarter with a $4.8 million loss, comparing favorably to the $5.6 million loss the budget calls for and the $10.2 million loss that occurred at the end of the first quarter of fiscal 2018. Management attributes the favorable variance to an unusually severe flu season. However, management concedes that CH faces operating headwinds through the remainder of the year, including payroll and health plan spending increases related to the onboarding of new physicians. CH maintains its target to achieve profitability by fiscal 2020, which we believe may be difficult to achieve.

CH's fiscal 2019 budget calls for 0.96x consolidated debt service coverage and 1.82x obligated group debt service coverage, based on an assumption of $5 million of realized investment gains (which we view as reasonable), which exceeds the bank's coverage requirements. We expect the obligated group to attain the required annual debt service coverage in fiscal 2019 to avoid a rate requirement violation, but we believe the organization as a whole is unlikely to generate 1.0x coverage.

Balance sheet stabilizes the financial profile

CH's unrestricted reserves are sound, which has been critical to weathering the operating challenges and EMR implementation. After a significant unrestricted reserve drawdown in fiscal 2018, reserves have grown through the first quarter of fiscal 2019. For fiscal year-end 2019, management projects unrestricted reserves to increase from fiscal 2018 levels. Management has no plans to spend down reserves.

CH has a high average age of plant, but given current financial performance and the recent EMR installation, it has no significant capital plans beyond funding depreciation. It also has no plans to issue additional debt.

Due to the possibility of acceleration, the $22 million of MHHEFA debt is classified as a current liability in the fiscal 2018 audited balance sheet. We have adjusted our data to reflect the $22 million as a long-term liability for the purposes of our cash-to-debt and other debt metrics.

Elevated levels of direct purchase bank debt

CH's leverage of 36% and debt burden of 3.6% are largely in line with our expectations for the 'BBB-' rating level, but contingent debt as a percentage of total long-term debt is elevated at 50%. CH's sound liquidity of 2.9x the contingent debt is critical because in our view, although the loan agreements include various cure periods, the organization does not have headroom under acceleration triggers. In addition to the required debt service coverage 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.

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 2018 was $8 million, translating to a funded status of 85%, which we view as manageable.

Table 2

Covenant Health Systems, Mass. -- Financial Statistics				
	--Three months ended March 31--	--Fiscal year ended Dec. 31--		
	2019	2018	2017	2016
Financial performance				
Net patient revenue ($000s)	167,355	637,079	639,553	616,136
Total operating revenue ($000s)	174,986	666,224	669,428	643,888
Total operating expenses ($000s)	179,895	727,902	674,962	650,482
Operating income ($000s)	(4,909)	(61,678)	(5,534)	(6,594)
Operating margin (%)	(2.81)	(9.26)	(0.83)	(1.02)
Net nonoperating income ($000s)	1,915	26,716	16,320	10,305
Excess income ($000s)	(2,994)	(34,962)	10,786	3,711
Excess margin (%)	(1.69)	(5.05)	1.57	0.57
Operating EBIDA margin (%)	3.12	(3.85)	4.13	4.31
EBIDA margin (%)	4.17	0.15	6.41	5.82
Net available for debt service ($000s)	7,378	1,056	43,984	38,046
Maximum annual debt service ($000s)	25,527	25,527	25,527	25,527
Maximum annual debt service coverage (x)	1.16	0.04	1.72	1.49
Operating lease-adjusted coverage (x)	1.12	0.22	1.59	1.40
Liquidity and financial flexibility				
Unrestricted reserves ($000s)	354,239	346,829	433,609	391,844
Unrestricted days' cash on hand	187.8	180.5	243.3	228.7
Unrestricted reserves/total long-term debt (%)	147.9	142.9	171.0	208.4
Unrestricted reserves/contingent liabilities (%)	294.9	288.7	354.7	770.7
Average age of plant (years)	14.9	17.1	17.6	15.8
Capital expenditures/depreciation and amortization (%)	46.1	216.7	213.6	80.2

Table 2

Covenant Health Systems, Mass. -- Financial Statistics (cont.)				
	--Three months ended March 31--	--Fiscal year ended Dec. 31--		
	2019	2018	2017	2016
Debt and liabilities				
Total long-term debt ($000s)	239,591	242,676	253,628	188,022
Long-term debt/capitalization (%)	35.8	36.9	34.1	29.6
Contingent liabilities ($000s)	120,127	120,127	122,257	50,842
Contingent liabilities/total long-term debt (%)	50.1	49.5	48.2	27.0
Debt burden (%)	3.61	3.68	3.72	3.90
Defined-benefit plan funded status (%)	N.A.	85.35	86.96	78.15

N.A.--Not available.

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. 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 two other senior living facilities across multiple states. While CH has considerable diversity, we consider it a stand-alone provider, as it does not meet our definition of a health care system as outlined in our health care criteria published in March 2018. The obligated group accounts for about 60% of total assets; 70% of long-term debt, which rises to over 80% if guarantees of non-obligated debt are included; and about 45% of total operating revenue.
- 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.