KaufmanHall

June 2022

Covenant Challenges Signal Need to Chart a Path to Sustainability

Lisa Goldstein and Dawn Samaris

Since the COVID-19 pandemic began, we have predicted that the pandemic will move through three stages: crisis, stabilization, and normalization. The crisis stage—and the response to it—was largely a monetary event. The Federal Reserve doubled down on what was already a highly accommodative monetary policy, and Congress passed several rounds of stimulus payments, totaling roughly $5 trillion. Just under $500 billion of the stimulus payments went to healthcare, including approximately $156 billion in grants to healthcare providers, including hospitals, to help alleviate budgetary gaps created by the operational disruptions caused by surges of COVID patients and shutdowns of non-emergency services.

We are now moving into the stabilization stage, and we have begun to address the credit and economic implications of the crisis response. For many hospitals and health systems, these implications are causing new operational and financial crises, which point toward a long and difficult road toward normalization:

- Total hospital expenses for April 2022 were up 8.3% year-over-year, according to data from Kaufman Hall's *National Hospital Flash Report*. Inflation in May rose to 8.6%, the highest increase since 1981.
- Hospital labor expenses increased more than one-third from pre-pandemic levels, and contract labor as a percentage of total labor expenses, increased more than 5 times the pre-pandemic rate, according to findings in a special Workforce edition of the *National Hospital Flash Report*.
- Ongoing operational disruptions from the Omicron variant of the coronavirus, combined with staffing shortages, have led to operating room shutdowns and the inability to fully staff beds, constraining capacity and contributing to declining volumes.
- At the same time, length of stay in April 2022 increased 3.5% year-over-year as hospitals dealt with higher acuity patients and throughput issues resulting in part from difficulties in discharging patients to full-capacity—and understaffed—skilled nursing facilities, which are declining referrals 10% more often than they did before the pandemic.
- The S&P 500 briefly fell into bear market territory in late May and again in mid-June; continued volatility in the market as the Fed continues tightening monetary policy will erode investment returns that have helped maintain balance sheet resiliency.
- Despite ongoing surges and operational disruptions of the Delta and Omicron variants, no additional federal funds have been authorized to help hospitals, and support from CARES Act funding is evaporating.

The possibility of breached covenants is a symptom of deeper problems. These are not problems that can be solved by the finance department alone; they will require an all-hands-on-deck approach to put the organization back on a sustainable path.

These factors have combined to produce four consecutive months of median negative margins for hospitals and health systems in 2022.

As many organizations approach fiscal year-end in June, potential breaches of debt covenants are an immediate concern. Debt is simply a promise to pay back borrowed funds; covenants, based on ratios such as debt service coverage or days cash on hand, are included in debt documents and routinely tested (e.g., on a quarterly or annual basis) to help ensure that the borrower is on track to keep that promise. If a covenant is tripped, creditors will have a range of remedies available to them, which may include the ability to demand immediate repayment of their investment. This potential outcome should drive borrowers to engage in remediation efforts or amendment processes with creditors.

The possibility of breached covenants is, however, merely a symptom of deeper problems. These are not problems that can be solved by the finance department alone; they will require an all-hands-on-deck approach to put the organization back on a sustainable path.

Taking immediate action on covenant management

Organizations should immediately prepare a debt covenant inventory, identify which covenants are at risk of being tripped, and understand the processes for remediation if a breach occurs.

Simultaneously, organizations should focus on financial planning that incorporates scenario testing to continuously assess covenant performance through time. Performance improvement plans also should be activated throughout the organization to help address potential shortfalls in cash flow or liquidity.

If a breach seems likely, early and transparent communication with the creditors is imperative. To try to avoid a breach, other actions could include:

- Realizing gains on investments, with the understanding that current market conditions may mean that those gains are reduced
- Drawing on lines of credit to avoid breaching a days-cash-on-hand covenant
- Consulting with auditors and bond counsel on the potential for extraordinary treatment of some expenses
- For academic medical centers, negotiating a "holiday" for medical school academic payments with their university partner

These are actions intended to mitigate an immediate threat. Whether or not that threat is averted, it should send a clear signal that leadership now must focus on long-term sustainability.

Turning the organization around

Many of the factors affecting hospital and health system performance today seem out of the organization's control. That may be true, but leadership can control its response to these factors and ensure that it is operating as efficiently as possible within the current environment.

Communicating with Board Members and Other Stakeholders

Board members, bank lenders and other creditors, and rating agency analysts are among the stakeholders that must be kept apprised of potential shortfalls in cash flow or liquidity and the organization's plans to address operational challenges now and over the long term. Tips for communicating with these stakeholders include:

- *Be proactive*. As soon as leadership becomes aware of potential problems, it should begin communicating with the organization's stakeholders.
- *Be specific*. Detail the likely size and duration of the potential performance gap and describe specific plans the organization has developed to address it.
- *Be transparent*. Make sure stakeholders are fully aware of the potential adverse impacts resulting from a covenant breach, including associated costs, potential creditor actions, possible impact on credit ratings, etc.
- *Be responsive*. Be open to questions from board members and other stakeholders and quick to respond to requests for additional information.
- *Be inclusive*. Engage leadership and the organization's stakeholders in discussions of the options available to put the organization on a more sustainable footing.
- *Be persistent*. Don't let deeper issues fade from view after an initial crisis passes; stay on message about the organization's need and plans to address these issues.

The focus on financial planning, scenario testing, and performance improvement described above should continue to provide the analytics necessary to define the challenges ahead, identify areas where new efficiencies can be realized or old efficiencies regained, and revise strategies to adapt to a changing environment.

The point about regaining old efficiencies is important, because one of the pandemic's impacts has been—understandably—to shift focus from efficiency to crisis management. As a result, some of the rigor around achieving performance metrics may have been relaxed. Organizations need to regain discipline around daily measurement of key indicators, including length of stay and staffing metrics. They face the additional challenge of a workforce that has been under tremendous physical and emotional stress; new indicators and creative thinking may be required to monitor the impact of performance improvement efforts on staff morale.

Rigor also needs to be restored within the physician enterprise. The median investment (or subsidy) per physician has crept up during the pandemic; data from Kaufman Hall's *Physician Flash Report* for the first quarter of 2022 show that the median investment/subsidy was at $288,227, for the first time surpassing the high levels seen at the start of the pandemic. Health systems must work to get this number back under control.

Capital expenditures are another lever leadership can pull to manage costs and liquidity. Leadership should revisit planned capital expenditures over the next five years, determine which are essential to the organization's sustainability and which are less so, and define the circumstances under which less essential projects will be given a "go" or "no go."

All opportunities for new efficiencies should be on the table. These might include forming a shared-services consortium with other provider organizations to reduce administrative costs or looking at outsourcing opportunities in areas such as revenue cycle or IT.

Exploring shifts in the business model

Taking a longer-term view, leadership should also consider potential shifts in the business model and strategic direction of the organization. This process should begin with conversations among the executive team and the board that define the organization's core capabilities and strengths, as well as capabilities they believe the organization will need to develop or acquire to maintain its relevance in the market.

With core strengths defined, leadership can also identify non-core services or assets. In some cases, these can be divested or monetized. In other cases—for example, in areas such as post-acute care or behavioral health where there are clear community needs for continued services—the health system might explore joint ventures, management agreements, or other partnerships with experienced, specialized operators. These partners may be able to both improve the margins on existing operations and grow the service line, with the health system sharing in the growth and revenue diversification.

Core strengths in administrative or clinical services may also provide opportunities for growth, such as provision of management services to regional physician groups or smaller hospitals. Leading health systems have created divisions with a mandate to diversify revenue in growth ventures outside of the delivery of healthcare services. Likewise, multi-site systems have consolidated clinical services to one or two facilities while others have discontinued services with low volume levels.

Leadership should also be monitoring changes in care delivery and payment models. The pandemic spurred significant growth in digital health, hospital at home, and other home health services. These changes may accelerate the continued migration of care from inpatient settings, and leadership will need to decide when and how much to invest in these new models to maintain or grow their market share and where partnerships can accelerate growth and progress.

Similarly, leadership should monitor the growth of Medicare Advantage plans in their market as the U.S. population continues to age. Medicare Advantage plans are on track to reach 69% of the Medicare population by the end of 2030, and health system leaders should consider opportunities for payer partnerships around these plans. Other payer partnerships around value-based care models could provide payment diversification that helps buffer fluctuations in fee-for-service volumes.

Conclusion: From crisis to sustainability

A famous piece of political advice says to never let a crisis go to waste. Health systems are facing a crisis on top of a crisis: they have managed through the crisis stage of the COVID-19 pandemic, and now face a new crisis as they deal with the implications of the response to the pandemic. All the more urgent, then, is the need for a multi-tiered response: work to contain the immediate damage of potential covenant breaches, implement a turnaround plan, and reset the organization's strategic course on a path toward sustainability.

For more information, please contact Lisa Goldstein (lgoldstein@kaufmanhall.com) or Dawn Samaris (dsamaris@kaufmanhall.com).