Meeting Debt Covenants During the COVID-19 Pandemic

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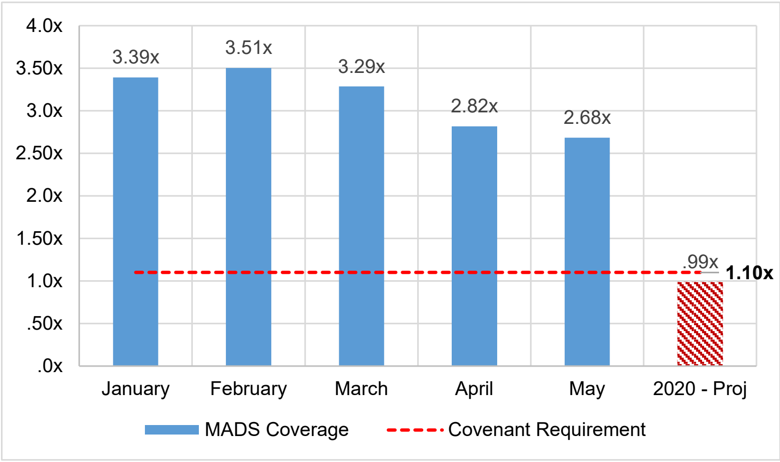
The COVID-19 pandemic has adversely affected the healthcare industry, causing sharp declines in revenue and cash flow. A large reduction in patient volumes due to cancelled elective procedures has hit many hospital systems particularly hard, especially those in states that continue to prohibit non-urgent care. In states that have lifted the ban on elective procedures, hospitals face the challenge of convincing patients that seeking treatment is safe. These measures have decimated the operating revenues of hospitals and healthcare systems, despite expenses remaining relatively flat, if not on the rise. All of these factors contribute to materially weakening financial performance and potential covenant breaches. In particular, income statement-based tests (e.g., debt service coverage ratios) will be especially susceptible to failure. What is a healthcare institution to do?



As hospitals and healthcare systems weigh the impacts of the current operational dislocations, they should evaluate whether or not a breach of financial covenants is likely to occur. A best practice for covenant compliance is to demonstrate performance against required levels to the board. This offers management a snapshot of operations and how they compare to required levels. As covenant definitions and frequency vary widely, it may be best to involve financial advisors, accountants and legal counsel in this step. For instance, are funds related to the CARES Act included in calculations? Professionals may also help the board understand the consequences of a failed covenant. Additionally, when reviewing financial covenants, it is crucial to look at all borrowing documents and any cross-default provisions. If any covenant is expected to be breached, it is always better to alert lenders early. The best-case scenario is of course not failing a covenant, but next best is failing a covenant "without any teeth." In this instance, covenant breaches will not constitute an event of default and may not even require the hiring of a consultant. The worst-case scenario would include an event of default and possible acceleration of monies borrowed.

Once a hospital or healthcare system has determined it is likely to breach a covenant, it will be vital to assess potential remedies of the breach under the governing documents (master trust indenture, continuing covenant agreements, loan agreements, etc.). This may allow the consequences to be avoided altogether. If no remedies are available, attempting to obtain a waiver from the lender(s) or bondholder(s) will be important. This process is more streamlined when negotiating with a single or a few commercial banks and becomes more complicated for public bond issues with multiple holders. In the case of public bonds, the governing documents normally dictate what percentage of investors are required to consent to a covenant waiver. Lastly, hospitals and healthcare systems should determine whether "force majeure" provisions exist in their documents and whether a force majeure event has been triggered. Based on a healthcare system's fiscal year end, covenant breaches may require attention sooner rather than later.

	January	February	March	April	May	2020 - Proj
Operating Income ($000)	$ 2,450	$ 2,501	$ 1,667	$ (783)	$ (278)	$ (105,000)
Interest Expense ($000)	2,127	2,127	2,127	2,127	2,127	26,582
Depreciation($000)	10,031	10,463	10,355	10,786	9,708	129,437
Net Income Available For DS	$ 14,608	$ 15,090	$ 14,149	$ 12,130	$11,556	$ 51,018
1/12th of MADS ($000)	4,305	4,305	4,305	4,305	4,305	51,661
MADS Coverage	3.39x	3.51x	3.29x	2.82x	2.68x	.99x

	Current	Test Period	Covenant	Comments
New Debt	100,000	25,000	25,000	Bank OK reqd

Example: Maximum Annual Debt Service Coverage calculation followed by an additional indebtedness test.

The coronavirus pandemic has affected many aspects of daily life and unfortunately for healthcare finance professionals, debt covenant breaches may have to be added to that list. With this in mind, being proactive is always the best approach, as it allows borrowers to evaluate all options. Additionally, conversing with lenders and asking permission typically results in better outcomes than begging forgiveness. Stay safe, stay healthy, and stay sane.