THE GOVERNANCE INSTITUTE

The Governance Institute presents

Managing Bond Covenants During Financially Challenging Times

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Presented by

Lisa Goldstein, Senior Vice President

Matt Robbins, Senior Vice President

Kaufman Hall

Today's Presenters

Lisa Goldstein
Senior Vice President, *Kaufman, Hall & Associates, LLC*

Lisa Goldstein is a nationally recognized analyst, speaker, writer, and expert on not-for-profit healthcare. At Kaufman Hall, she is a member of the Treasury and Capital Markets practice and Thought Leadership team.

Prior to joining Kaufman Hall, Lisa spent more than 30 years at Moody's Investors Service, including 10 years serving as Associate Managing Director. She managed the rating agency's U.S. not-for-profit healthcare ratings team and oversaw credit rating and monitoring for 350 not-for-profit hospitals. Lisa holds an M.P.A. in public and non-profit finance, management, and policy from the New York University Robert F. Wagner Graduate School of Public Service.

Matt Robbins
Senior Vice President, *Kaufman, Hall & Associates, LLC*

Matt Robbins is a leader in Kaufman Hall's Mergers and Acquisitions, and Treasury and Capital Markets practices. He provides partnership and financial advisory services for a broad range of healthcare clients engaged in various types of transactions, such as borrowings, debt restructurings, derivatives, mergers, acquisitions, and joint ventures.

Matt has experience advising healthcare leaders on capital markets activities. His specific areas of expertise also include acquisition financings, master indenture consolidations, bondholder and creditor negotiations, bondholder tenders, and debt redemptions. Prior to Kaufman Hall, Matt worked in the Non-Profit Healthcare Finance Group at Citigroup Global Markets, Inc. He holds the Chartered Financial Analyst® designation.

Learning Objectives

After viewing this Webinar, participants will be able to:

- ✓ Identify the factors associated with potential covenant violations
- ✓ Describe the potential consequences of covenant violations
- ✓ Outline a process for identifying, avoiding, communicating, and remedying violations

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Continuing education credits available

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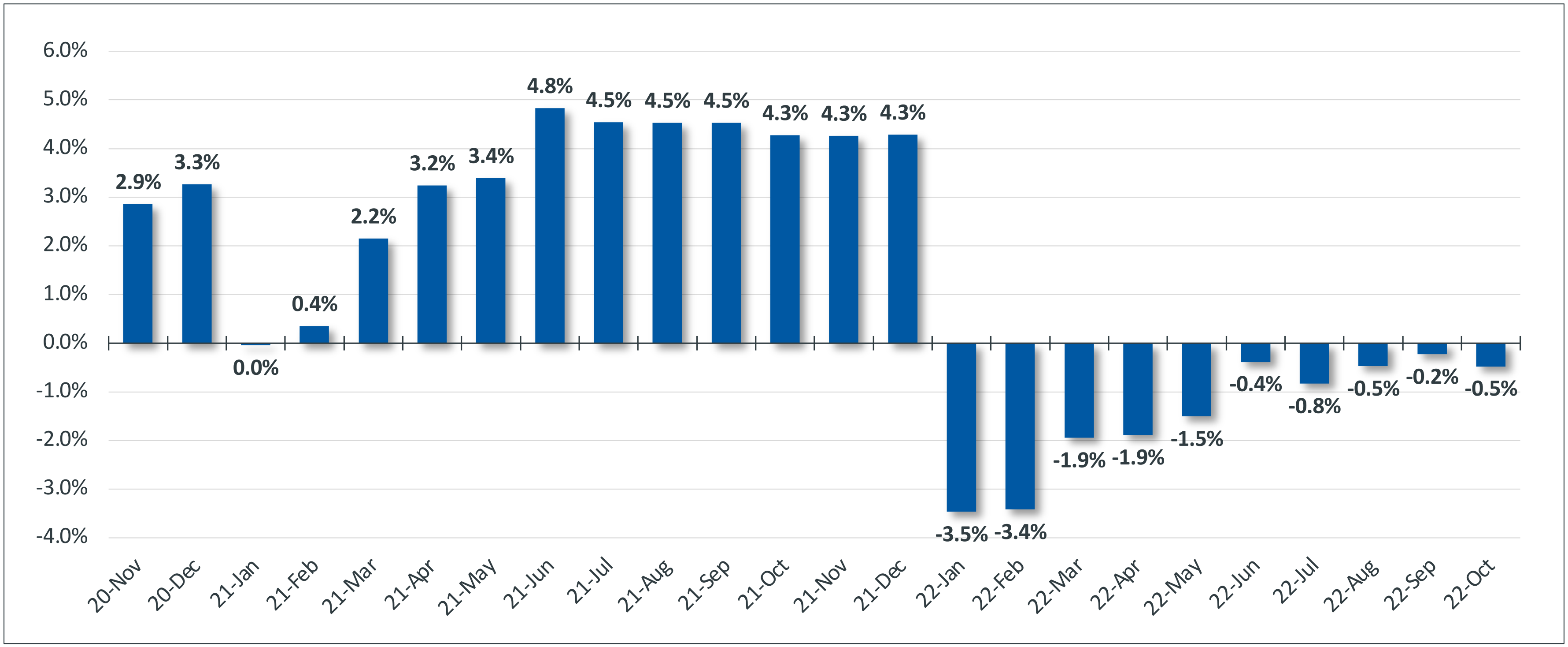
Weak Performance in 2022 Raises Risk of Covenant Breaches

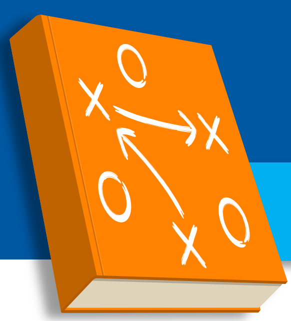
Kaufman Hall Operating Margin Index™ YTD by Month



* Note: The Kaufman Hall Hospital Operating Margin and Operating EBITDA Margin Indices are comprised of the national median of our dataset adjusted for allocations to hospitals from corporate, physician, and other entities.

Covenant Management Playbook

Adopt a sustainable communication strategy for the board, management team, rating agencies, credit banks, and bondholders



1. Understanding key financial covenants in the MTI and credit agreements and whether the MTI and/or credit agreements need amendment or waivers
2. Develop detailed Performance Improvement plans that identify:
   - Key drivers causing the potential breach
   - Near- and long-term strategies and tactics to improve financial performance
   - The organization’s plan to execute, measure, and monitor its performance improvement plans
3. Integrate Performance Improvement plans with Financial Planning to articulate improved financial performance
4. Measure, monitor, and communicate results proactively

The combined playbook is essential to communicate with various stakeholders

Sample Beginnings of a Covenant Catalog

SERIES	Par	Structure	Covenant Source	Call Date	Call Price	Credit Provider	Put/Renewal Date	Final Maturity
2003	30,000,000	Fixed Rate	Public: MTI	Non-Callable	N/A	—	—	June 15, 2023
2011	56,000,000	Fixed Rate	Public: MTI	June 15, 2021	100%	—	—	June 15, 2041
2017	120,000,000	Fixed Rate	Public: MTI	June 15, 2027	100%	—	—	June 15, 2047
2018	27,000,000	Direct Purchase	Private: Banks 1&2	Any IPD	100%	Bank #1	December 1, 2031	August 1, 2038
Term Loan	10,000,000	Term Loan	Private: Banks 1&2	Anytime	100%	Bank #2	—	January 1, 2038
Line of Credit	15,000,000	Line of Credit	Private: Banks 1&2	Anytime	100%	Bank #1	—	June 6, 2021
Line of Credit	25,000,000	Line of Credit	Private: Banks 1&2	Anytime	100%	Bank #2	—	May 10, 2021
TOTAL	**283,000,000**							

COVENANT	Public: MTI	Private: Banks 1&2	Minimum Needed	Definition Tracking	Definition Specifics
Debt Service Coverage	1.15x DSCR (consultant call-in); < 1.00x (Default) annual	1.15x DSCR (Default), quarterly	Minimum Net Income Available for D/S needed for **1.15x DSCR - $____M** **1.10x DSCR - $____M**	• Income Available for Debt Service and Components • Debt Service (Maximum or Annual)	• Carve out for extraordinary expenses
Days Cash on Hand	N/A	90 DCOH, semi-annually	Unrestricted Cash can drop to approximately **$___M** or Average Daily Operating Expenses can increase by **$_____**	• Operating Expenses	• Alternative investments included?
Minimum Ratings	N/A	Baa3/BBB-	Borrower would need to be downgraded **___notches** to reach the minimum threshold	• Which Rating Agencies	

EVENTS OF DEFAULT	Reporting	Rate covenant	Days Cash on Hand	Timing/Who gets it	Definition Specifics
Public: MTI	Annual audit	Annual	N/A	135 days after FYE to Master Trustee	30 day cure; can't get audit if EOD
Private: Banks 1&2	Quarterly financials	Quarterly DSCR	Semiannual	• 45 days after QE; Banks 1&2	• Slightly different than MTI

Health System Actions Taken to Proactively Manage Covenant Concerns

- **Reduce current planned projects**
  - Review current in-flight capital and total estimated spend for the year
  - Discuss projects that can be delayed or eliminated
- **Evaluate reductions to staff, furloughs, and elimination of premium pay**
  - Tool used at beginning of pandemic
  - Potential impacts to recruitment/retention given market competition
- **Look for opportunities to sell investments and realize gains**
- **Consider changes to the obligated group's membership**
- **Explore state/external support funding**
  - Potential ability to access external support?
- **Suspend pension contributions**
  - What is the estimated savings? Historic contributions and current funding level?
- **Seek classification of some 2022 expenses as "extraordinary"**
  - Workforce/contract labor? Business disruption?
- **Consider changes to academic support funding**
  - How are payments currently calculated? History of academic support "holiday" in the past?

Examples of Technical Covenant Defaults and Capital Markets' Reaction

Presence Health℠

Chicago Health System

$3.0B of Revenue

BBB-category credit

- $200M+ of Accounts Receivables and Medical Malpractice write-downs in 2015
- Resulted in breach of 1.0x Rate Covenant
- Pursued waiver of default with banks and bondholders—efforts proved unsuccessful
- Decided to pursue a $550M bridge loan to refinance all bank debt, which waived the default for that fiscal year
- Following bridge loan completion, launched public market refinancing of all legacy debt
- Downgraded two rating notches to Baa3/BBB-
- **Underlying business was losing money and absolute cash levels were low**

Bon Secours

Mid-Atlantic Health System

$3.0B of Revenue

A-category credit

- 2008-09 Financial Crisis resulted in combination of investment losses, swap and pension revaluations that pushed balance sheet past 65% debt-to-cap covenant
- Debt-to-cap covenant was only with bond insurer (Assured Guaranty) and Letter of Credit banks—approached in tandem for waivers of default
- Replaced some banks to achieve necessary relief
- Assured Guaranty granted waiver, but included several onerous provisions to reduce their exposure (swap terminations, bond refinancings, etc.)
- **Underlying business was sound, covenant default viewed as "balance sheet issue"**

Managing Credit and Covenants

- Communication with rating agencies, investors, and banks is important if a breach is likely

- A downgrade is not necessarily automatic if there is a breach, but narrows the bandwidth of rating tolerance

- Analysts will want to understand:
  1) The drivers causing the breach;
  2) How are you proactively managing the breach; and
  3) Near-term and long-term strategies to improve financial performance and preclude future violations

- Headroom to the covenant(s) is an important financial metric for rating agencies

Scenario Planning Can Support Communication of the Sustainability Path as well as Key Risks and Mitigators

1. What is required to reach a sustainable operating path? What are key associated assumptions and factors driving uncertainty?
2. How do we stress-test our financial trajectory and strategy in light of changing market conditions?
3. How do we ensure the resiliency of our organization by pivoting our decision-making? What mitigation levers are available?

Approach			
	Quantify the long-range financial trajectory	Stress-test the results and identify key drivers, risks, and opportunities	Monitor actual performance and market developments and communicate transparently

Path to Sustainability Must Be Socialized and Proactively Communicated

When communicating with board members and other stakeholders:

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.

Questions & Discussion

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