COVER STORY EXPERT REVIEWED

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Healthcare providers face a **growing risk** of violating debt covenants

Organizations are facing a heightened financial risk environment with roots deeper than the COVID-19 pandemic. Fortunately, there are steps they can take to protect themselves — and their futures.

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COVID-19 has increased the financial strain on healthcare providers, but that strain predates the pandemic. The pandemic simply exacerbated an existing trend of financial weakness in the U.S. healthcare system. And that trend will have far-reaching consequences even beyond the pandemic.

For provider organizations, those consequences include increasing difficulties in maintaining liquidity and meeting loan covenant obligations. The fact that many organizations already have violated debt covenants raises concerns for the future financial stability of the hospital sector. It therefore behooves healthcare finance leaders to be mindful of the potential risks their own organizations face of violating lending covenants. The sidebar on page 3 discusses the potential threats to providers' financial well-being that could put them at increased risk of such circumstances.

TYPICAL LENDING COVENANTS, AND THEIR RISING RISKS

Lending arrangements, including bond issuances, that were entered into before the pandemic assumed operating conditions would remain normal. Obviously, that assumption was turned on its head, with unexpected consequences for maintaining debt covenants.

Two types of debt covenants are most common: **debt-service-coverage ratios**, which require an organization to keep a specific ratio related to how many times net revenue can cover debt service payments, and **days-cash-on-hand ratios**, which require organizations to maintain a certain amount of days cash on hand. Both face adverse effects from COVID-19.

Debt-service-coverage ratios are declining due to decreases in revenue and margins affecting almost all U.S. hospitals. The negative pressure on debt-service-coverage ratios has been driven by skyrocketing nursing, clinical and medical supply costs combined with a decline in elective procedures. As a result, even hospitals that had breakeven or slightly positive margins have seen their margins go negative.

Moreover, the extended negative margins have, in turn, put pressure on cash reserves of many healthcare providers, automatically producing a decline in their days cash on hand.

Deteriorations in both these ratios are endangering healthcare organizations' abilities to meet their lending covenant obligations.

CONSEQUENCES OF COVENANT VIOLATIONS

Violating a debt covenant can have a downward spiral effect on an organization's ability to continue as a going concern.

One major consequence is a downgraded credit or bond rating, if applicable, which can damage leaders' confidence in the organizations' financial viability. As a result, the organization's cost of borrowing may increase, worsening the financial consequences of the initial violation.

Covenant violations also can lead to administrative stresses. For example, the organization might be required to appoint a financial adviser to monitor its financial affairs, which would impose significant demands on its financial team and consume valuable resources, including time, money and talent.

Lack of access to state-of-the-art medical equipment is another side effect of financial stress. A provider whose medical equipment is outdated will be less capable of attracting top-class clinical talent, and by working with aged equipment, it will face a greater overall risk of malpractice and potential litigation.

Such a downward spiral set in motion by a debt covenant violation is difficult to counteract.

SIGNS OF HEIGHTENED RISK

Several red flags indicate that an organization is at a heightened risk of violating lending covenants. These signs include the following.

Supply chain disruptions. Difficulty accessing resources can go beyond cost barriers. An organization that is struggling to find suppliers because of supply chain delays that prevent it from restocking its inventories may see a negative impact to its ability to deliver care.

Low patient volume. Continuing low patient volume could add further strain to an organization's finances, particularly if the reduced volume is tied to a decrease in elective procedures.

Staffing shortages. Organizations that are experiencing staffing shortages — whether from burnout, difficulty in retaining top talent or some other cause — may struggle to provide the volume and quality of care needed for financial sustainability.

Payroll inflation. Organizations that are seeing significantly higher payroll costs because of reliance on registry services due to staffing shortages are at a greater risk of financial distress.

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14.4%

Increase in healthcare providers' total expense per adjusted discharge through 2020

Source: Gelbaugh, C., *2021 strategic planner survey results*, Advisory Board, March 30, 2021

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Looming challenges threaten healthcare's current financial stability

Throughout the pandemic, several factors converged to create financial stability in the U.S. healthcare system. Yet that stability could well be short-lived.

First, the Provider Relief Funds (PRF), dispersed under the CARES Act, gave healthcare providers access to enough money to keep them afloat. As of the time of writing, $25.5 billion in new funding was available for providers on the frontlines of the pandemic. This funding included $8.5 billion in American Rescue Plan (ARP) resources for providers that serve rural Medicaid, Children's Health Insurance Program (CHIP) or Medicare patients, and an additional $17 billion for PRF Phase 4 for a broad range of providers that can document revenue loss and expenses associated with the pandemic.

Second, for those that have the ability to borrow from the credit markets, the cost of borrowing has been reduced due to sustained low interest rates since the last economic downturn.

27%

Percentage of healthcare CFOs responding to a 2021 survey who reported their organizations had more than 60 days of cash on hand prior to the pandemic

Source: BDO, *2021 BDO healthcare CFO outlook survey*, 2021

Challenges /consequences

However, with these opportunities come challenges — and consequences.

Healthcare organizations are facing an inflationary environment due to COVID-19. Costs related to payroll, technology, capital and supply chain have increased sharply. In fact, according to Advisory Board, healthcare providers saw a 14.4% increase in total expense per adjusted discharge throughout 2020. As a result of these rising costs, many of the funds received under PRF and other grand programs have quickly depleted.

Furthermore, due to confusion about how organizations are permitted to use these funds, some organizations will likely have to either pay back a portion of the money or forfeit it. Compliance and regulatory requirements pursuant to these funds have added additional burdens for all providers, and the attractive borrowing environment is likely to disappear in the not-too-distant future as the economy becomes overheated and we begin seeing inflation and rising interest rates. The economy's behavior is something of a wild card, however, as the trajectory of its health and the timing of changes in borrowing rates are difficult to predict.

In addition, other COVID-19-related challenges — including sustained reductions in elective procedures, potential future surges of COVID-19 and staffing challenges — are continuing to wear down the financial resilience of healthcare providers nationwide.

Underlying weakness

These challenges are compounded by the underlying weaknesses that already plague the U.S. healthcare system. A recent poll by BDO of 100 healthcare CFOs found that, prior to the pandemic, only 27% of the respondents' organizations had more than 60 days of cash on hand, while 46% had 31 to 60 days of cash on hand. Moreover, 44% said maintaining adequate liquidity would be a high or moderate.

Given that liquidity is often a major lending covenant requirement and an indicator of an entity's ability to meet its short-term obligations, the implications of these statistics are troubling.

Capital project commitments. Large existing capital projects such as construction contracts or large-scale technology implementations could significantly strain an organization's finances.

THE PATH FORWARD

Leaders who are concerned their organization may default on its covenants, or know that it already has defaulted, should take the following steps to minimize the damage incurred.

Evaluate your strategies to boost revenue and reduce costs. This should be the first step, and it should be taken as soon as possible. An organization's best protection from a default is in ensuring it can maintain the ratios associated with its covenants. It therefore should explore options for increasing its revenue (e.g., prioritizing increasing elective procedures) and reducing costs (e.g., purchasing alternative, more cost-effective medical supplies, when possible).

Bring the issue to your lending counsel and financial advisers. An organization's counsel can play a crucial role in renegotiating agreements or bond indentures where applicable and helping the organization grasp the risk of a violation. The organization should discuss these risks in concert with its financial advisers to obtain a full picture of the potential consequences it is facing and options for addressing them.

Understand the implications on financial statements. The organization should consult its financial advisers and auditors to understand whether the violation might lead to the possible inclusion in the audit opinion of an *emphasis of matter* paragraph regarding the organization's ability to continue as a going concern, and what the implications of such a result might be.

Understand the underlying causes of your violation. An important consideration is whether the violation was spurred solely by COVID-19 or other issues caused the default. The organization should take some time to research the default's causes and consider how they may be resolved.

Halt or delay additional financing activities. Until the implications of the covenant violation are understood, the organization should avoid taking on additional financial responsibilities. In particular, it should carefully consider the implications of borrowing additional monies from other lenders if it is in danger of violating an existing covenant. Why? Because defaulting on one obligation may automatically cause the organization to default on its other obligations, which would expand the number of creditors it must deal with.

Halt or delay any large capital or technology projects. Evaluate the impact of halting or delaying any major capital or technology projects, including assessing the impacts of penalties, impairments and even the impact of the opportunity cost of such an action.

Reevaluate leasing decisions. As another way to reduce existing financials obligations, the organization may want to reconsider any plans it has to lease a major piece of equipment and hold off on those plans until it can address the violation.

Reconsider budgets. Any approval of budgets should be delayed until the violation is addressed. It is a good idea to implement zero-based budgeting to ensure the organization's money is being used as strategically as possible. No part of the budget should be set in stone based on historical budgets. This policy also is a good way of preventing a violation.

Understand the impacts of a downgraded bond or credit rating where applicable. If the organization's rating is downgraded due to a covenant violation, it needs to take steps to understand the impacts of the downgrade. A downgrade could automatically lead to increased borrowing costs. The organization's leaders should consider whether the violation is a minor blip that will even out in the near future, or if it represents a long-term impact of financial distress. They then should be sure to share their conclusions clearly with the organization's internal stakeholders and consult with its advisers regarding how best to communicate findings to other stakeholders, including lenders.

IMMEDIATE ACTION REQUIRED

Covenant violations are serious and can have major impacts to a healthcare organization. However, with the right approach, an organization can address the violation and get back on track. The key is acting proactively and decisively. By addressing a violation as soon as or, ideally, even before it occurs, it's possible to mitigate the severity of the consequences and set the stage for improving the organization's financial health in the long term. ∎

About the author

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