S&P Global
Ratings

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Tower Health, Pennsylvania; System

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Long Term Rating	BB+/Negative	Downgraded

Rating Action

S&P Global Ratings lowered its long-term rating to 'BB+' from 'BBB+' on the taxable and tax-exempt bonds outstanding issued for Tower Health, Pa. The outlook remains negative. Tower Health had $1.3 billion of long-term debt outstanding at June 30, 2020.

The three-notch downgrade reflects the significant deterioration in Tower Health's financial profile in the fiscal year ended June 30, 2020, including a severe loss from operations and negative cash flow resulting in inadequate debt service coverage (DSC) ratios. The losses resulted from underlying operating issues that were further exacerbated by the COVID-19 pandemic. S&P Global Ratings' coverage calculation, which accounts for system-level results and assumes maximum annual debt service (MADS), shows negative coverage, based on 2020's performance. Tower Health's coverage covenant pursuant to its master trust indenture (MTI) reflects obligated group financials. According to this calculation, coverage is less than the 1x event of default threshold in the MTI, excluding any adjustments related to COVID-19. Tower Health, in consultation with its advisors and outside counsel, indicated in an Oct. 28, 2020, disclosure that an event of default has not occurred, based on its interpretation of the provisions of the indenture, and that it also plans to engage a restructuring consultant in early November. Our downgrade fully factors in our view of the multiyear credit deterioration that underlies the results that led to the coverage outcome, regardless of whether it was considered an event of default. Lastly, the rating action reflects our weakening assessment of the enterprise profile. In our view, the continued lack of intended results, including financially, from recent-year acquisitions lessens our view of the strength of recent-year growth.

Credit overview

The 'BB+' rating reflects our view of Tower Health's vulnerable financial profile, which has progressively worsened during the last few years. While the system has grown in size beginning in 2017 with the acquisition of the Chester Montgomery Philadelphia (CMP) hospitals and other strategic growth such as the joint acquisition of St. Christopher's Hospital for Children (SCHC) out of bankruptcy, these investments have failed to show meaningful financial progress and continue to be a drain on overall system performance. The organization was not in a position of strength going into the COVID-19 pandemic, as demonstrated by operating losses through Feb. 28, 2020. In March, Tower Health began to feel the strain of the pandemic, including from increased expenses for staff and personal protective equipment and also from significant declines in volume from government-mandated restrictions on nonessential care. Consistent with industry trends, volumes have grown since the low points in March and April, but still remain below prepandemic levels for most key utilization statistics. Tower has received Coronavirus Aid, Relief, and Economic

Security (CARES) Act grant funds, but those have not nearly offset the bottom-line impact to the organization. The combination of underlying operating issues and the effects of the pandemic has resulted in a doubling of Tower Health's operating loss in fiscal 2020 compared to fiscal 2019, which was also extremely weak.

Tower's negative financial performance has also led to further erosion of the balance sheet. Specifically, the deterioration of unrestricted net assets coupled with Tower's elevated debt load has resulted in leverage consistent with a speculative-grade credit profile. Moreover, liquidity, while still sufficient from a days' cash on hand (DCOH) perspective, provides much less cushion. We view this as a risk particularly given the heightened risks to the health care operating environment as the pandemic continues and because of the volatility of Tower Health's performance in recent years.

Overall, with the decrease in earnings and balance sheet strength, we believe Tower Health's overall financial profile has worsened to a level that we consider vulnerable.

Our rating continues to reflect the potential enterprise profile strengths such as the size and diversity of the growing delivery system; however, this favorable stance is diminishing as the acquisitions in recent years continue to struggle and as profitability is derived solely at the legacy Reading Hospital. Our continued assessment of the enterprise profile as strong is anchored, at this time, in the strength of the flagship. In addition to operating improvement initiatives that were already underway, we understand that management is engaging a turnaround consultant to evaluate other options for the system. As a result, we anticipate that some aspects of the system could change in the near term. We will continue to evolve our view on this aspect of the credit profile based on future plans and management's execution on those plans.

More specifically, the rating reflects our view of the risks associated with Tower Health's:

- Substantial losses in fiscals 2020 and 2019 driven by the CMP hospitals and Tower Health Medical Group (THMG);
- Negative cash flow in fiscal 2020 at the system level and less than 1x DSC for the obligated group during this same period;
- Ongoing execution efforts needed to fully realize the strategic and financial benefits of the new hospitals acquired in 2017, the SCHC acquisition, and Drexel University College of Medicine (DUCOM) faculty investments, as well as other growth endeavors;
- Weak balance sheet, specifically as it relates to a very high leverage position and very thin unrestricted reserves to debt; and
- Underfunded pension, with a funded status that trails median levels, although it has been frozen to all participants since June 2016.

In our opinion, mitigating credit factors include:

- The strength of the flagship Reading Hospital, which generates good cash flow to help offset some of the losses of other system assets;
- Tower Health's still-adequate liquidity position from a DCOH perspective;
- The system's much more conservative debt profile following the February 2020 plan of finance, which eliminated

swaps and direct placement debt; and

- Positive operating cash flow through the first quarter of fiscal 2021 when including CARES Act grant funds.

The negative outlook reflects our view of Tower Health's much weaker financial position and our expectation that operating losses will persist in fiscal 2021. While we understand that management has initiatives underway to improve operations, we believe the magnitude of the losses creates a difficult path to recovery, particularly given that volumes are not yet at prepandemic levels. Also, we believe continued investments to build out Tower Health's nascent, evolving system, along with likely losses at the CMP hospitals, will weigh on the financial profile in the near term until certain strategies take hold.

Environmental, social, and governance factors

We view social risk as in line with sector peers. The core mission of health care facilities is protecting the health and safety of communities, which includes the responsibilities to serve the surge in patient demand ill with COVID-19 as well as government restrictions on nonemergent care. We believe this has exposed Tower Health and its peers to additional social risks that have presented and could continue to present financial pressure in the short term. We believe environmental and governance risks are in line with our views of the industry as a whole. However, we do believe that governance will be a critical factor in the year ahead, as the system's recent-year strategies have not led to the desired results and management and governance will likely need to make difficult decisions as they develop strategies to turn around Tower Health. We believe these decisions will have a direct effect on future credit quality.

Negative Outlook

Downside scenario

We would consider a lower rating without demonstrable improvement in Tower's underlying operating performance in fiscal 2021, including management meeting its 2021 financial performance targets. Tower is targeting to be cash flow positive from operations (before investment income) at the system level in fiscal 2021 with an operating EBITDA margin percentage in the low single digits. Failure to meet that target would result in a further downgrade. We think days' cash is sufficient at the 'BB+' rating, but could quickly weaken if cash flow targets are not met. Therefore, we think maintenance of current liquidity is also important to maintain the rating. Lastly, we think that a continued negative shift in our view of the enterprise profile could affect the rating. This could occur with inadequate progress toward turnaround plans.

Return to stable scenario

An outlook revision back to stable would require stabilization of operations and a clear, articulated path to sustainable results for the system at least approaching break even. Also, given the drain of recent-year strategic investments, we would expect a clear demonstration of management's plans to make these assets financially viable in order to return the outlook to stable. Stability in the balance sheet with no further deterioration in metrics would also be required for a stable outlook.

Credit Overview

Enterprise Profile: Strong

Evolution to an integrated delivery system and academic medical center

In December 2018, Tower Health began to develop the academic arm of its growing delivery system by augmenting Reading Hospital's teaching program with a formal partnership with Drexel University (Drexel) to develop a new school of medicine in West Reading. In 2019, this strategy accelerated quickly, in our opinion, partially due to opportunities created by changes in the Philadelphia market, specifically the bankruptcy filing of American Academic Health Systems LLC (AAHS). AAHS' filing resulted in the closure of Hahnemann University Hospital (HUH) and scaling back of programs at SCHC, both of which were primary teaching sites for DUCOM. In our view, these events likely served as a catalyst to propel the strategy forward with the movement of several other large events touching Tower Health including signing a 20-year academic affiliation agreement with Drexel. Drexel University Physicians have also joined the THMG. Tower intends to grow to have 600 residents across the system by 2025 as well. To date, management has not provided a comprehensive pro forma of the operational, financial, or structural details of how all the pieces will fit and work together as it develops the academic medical group. Therefore, we can't assess the full impact on the financial and enterprise profiles, if any. However, we do believe that the strategy is ambitious and brings execution risk inherent with these major undertakings, particularly in the competitive and consolidating region in which Tower Health operates. The region includes other large health systems and multiple well-established academic medical centers.

In January 2020, Tower Health and Drexel closed on the acquisition of SCHC for $50 million. This both added a children's component to the Tower Health delivery system and allowed SCHC to continue to serve patients and host residents. This is a 50/50 endeavor, but Tower Health is the managing partner. SCHC contributed to the operating losses in fiscal 2020, and we expect that it will continue to generate losses in the coming years, as we anticipate a need to reinvest in service lines and restore volumes that may have been lost in recent years while the organization was heading to bankruptcy.

In 2019, Tower Health added to the system's quaternary capabilities by executing an agreement that resulted in the entire kidney and liver disease transplant team moving from HUH to Reading Hospital and Chestnut Hill Hospital. Tower completed its first organ transplant in May 2020. We expect that this program will initially have some start-up losses, but will mature as it develops.

Construction of the DUCOM in West Reading is underway and is being built near the campus of Reading Hospital. Operations are slated to begin in the 2021-2022 academic year, with 40 medical students per class. Once the campus is fully operational, management expects it will have 200 medical students. We expect that the new joint venture (JV) would yield modest operating losses in the early years until the operation reaches critical enrollment.

The Chester/Montgomery/Philadelphia hospitals

Tower Health completed the acquisition of five former Community Health Systems (CHS) hospitals on Oct. 1, 2017. The CHS facilities included 753 licensed hospital beds. Tower Health also gained three ambulatory surgery centers, six

outpatient centers, medical office buildings, and several other primary and specialty care sites. The acquisition also resulted in an expanded service area including Berks, Montgomery, and Chester counties.

The CMP hospitals have had significant losses during the last two fiscal years after posting a slight operating gain in their first year integrated within Tower Health (fiscal 2018). In 2019, management encountered numerous issues in the revenue cycle that resulted in considerable revenue write-offs and increased receivables. In our opinion, these issues masked many of the underlying challenges that the newly acquired hospitals were facing in the first year of integration. Specifically, investments in physicians, staff, and technology at the CMP hospitals were greater than management expected. In addition, volumes were not growing according to plans. Management has taken action to resolve the revenue-cycle issues by terminating an outsourced vendor and replacing it with in-house revenue cycle staff and another vendor, both with experience in the Epic platform.

While the revenue cycle issues appear to be resolved, the CMP hospitals struggled again in fiscal 2020, posting a $183 million loss from operations (compared with a $140 million operating loss in fiscal 2019). The COVID-19 pandemic certainly contributed to the losses at the CMP hospitals in fiscal 2020, but underlying operating issues still persist and materially contribute to the losses.

We expect that the CMP hospitals will be a drain on the system financially in the near term. Tower Health's leadership is seeking expense efficiencies, which we view positively, but we believe it will be even more important to increase volumes and revenues to support the overall system, which we expect will be more challenging during the current operating environment where volumes have not reached pre-COVID-19 levels yet. We expect that, given the challenges to date, management will also evaluate the strategic fit of these assets within the system.

Table 1

Tower Health--Enterprise Statistics

	--12 months ended June 30--	--Fiscal year ended June 30--		
	2020	**2019**	**2018**	**2017**
PSA population	N.A.	N.A.	N.A.	283,985
PSA market share (%)	N.A.	N.A.	N.A.	65.9
Inpatient admissions	58,284	58,548	52,001	29,924
Equivalent inpatient admissions	127,520	116,424	107,897	60,473
Emergency visits	246,409	278,899	243,296	133,559
Inpatient surgeries	12,249	14,307	11,880	7,135
Outpatient surgeries	16,827	23,594	19,045	6,023
Medicare case mix index	1.5542	1.5683	1.5381	1.6497
FTE employees	11,899	10,462	9,552	6,174
Active physicians	2,537	2,047	1,876	687
Based on net/gross revenues	Net	Net	Net	Net
Medicare (%)	42.0	30.0	35.0	47.4
Medicaid (%)	12.2	12.0	11.0	19.1
Commercial/Blues (%)	39.4	52.0	50.0	28.6

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

Financial Profile: Vulnerable

Operating issues compounded by COVID-19 result in significant loss

Tower Health lost $407 million from operations based on the unaudited results for the 12 months ended June 30, 2020. The lost revenues and increased expenses from the COVID-19 pandemic were a significant contributor to the magnitude of the fiscal 2020 loss, but underlying issues were evident prepandemic. The effects of the pandemic began to affect Tower in March 2020, consistent with national trends. Due to government restrictions on nonemergent care in March and April combined with patients' reluctance to seek care because of concerns of contracting COVID-19, volumes plummeted. Volumes have trended upward beginning in May 2020 but remain below prepandemic levels across the system. Expenditures also increased during this period as supply costs rose, as did premium pay for clinicians. Although CARES Act grants helped, as did management's actions to offset losses--including through the furlough of 1,000 employees and closure of some programs--the efforts were not nearly enough. This is evident in the rapid deterioration of financial performance from February through the end of the year. Management indicated that the system's operating loss through Feb. 28, 2020, was about $60 million. This increased to a $132 million year-to-date loss by March 31, 2020, which further widened to the $407 million loss from operations for the fiscal year. The year-end results include $81 million of CARES Act grants.

The year-end results produced negative bottom-line cash flow for Tower Health. We estimate EBIDA at negative $215 million (including realized investment gains), generating negative 2x coverage based on MADS of $90.7 million. Our MADS figures smooth bullet maturities and reflect increased lease payments that resulted from the completion of Tower's sale-leaseback transaction of certain properties that occurred in June 2020.

Through the first quarter of 2021, results are weak, but better than recent trends. Operating income through Sept. 30, 2020, is negative $32 million. This figure includes the final $42 million of CARES Act grants received by Tower to be recognized as income. Management budgeted an approximately $74 million loss for the first quarter of fiscal 2021 based on trend and excluding CARES Act grants. It met this target.

Management has created a base-case budget for the remaining nine months of fiscal 2021. That, combined with actual results for the first quarter, calls for a $163 million loss from operations (inclusive of $42 million of CARES Act grants) for the full fiscal year. Operating EBIDA (excluding investment income) is projected by management to be about $18 million. These targets include management's assumption that volumes will remain below prepandemic levels but in line with recent volumes. It also assumes $127 million of operational improvements as part of its Transformational Excellence program. The board has approved the budget, but with the expectation that additional improvements will be added through the acceleration of transformation efforts and through upcoming work to be completed with a turnaround consultant.

In our opinion, the forecast contains reasonable assumptions, but there is ample uncertainty associated with Tower's ability to achieve the budget given the unpredictability of volumes during the pandemic. Also, the target is highly reliant on the ability to execute on significant operational turnaround initiatives. A notable action toward this goal was Tower's recent move to reduce 773 full-time-equivalent employees in mid-June 2020, which is expected to generate $76 million of annual savings.

Liquidity and financial flexibility

Tower Health's liquidity has historically been solid and one of the system's stronger credit factors. However, DCOH declined steadily in each of the last four audited years. The increase in average daily expenditures as the system grew contributed to this, but actual unrestricted reserves also fell in fiscal 2019. We calculate unrestricted reserves at $674 million at June 30, 2020, which is comparable to the $684 million that Tower had at the close of fiscal 2019. The monetization of noncore assets in June 2020 through a sale-leaseback transaction helped offset the cut to unrestricted reserves Tower experienced from negative cash flow in fiscal 2020. These transactions added about $200 million to unrestricted reserves and are included in the $674 million. Given the financial strain, Tower is also limiting capital spending to life-safety investments to help preserve cash. Tower has also taken the opportunity to defer FICA payroll taxes through December 2020, providing a $25 million reduction in cash outflows for the remainder of the year. These taxes will ultimately need to be repaid in December 2021 and December 2022.

Consistent with our treatment across the health care sector, we have excluded Medicare Advanced and Accelerated Payments (MAP) as well as short-term borrowings from our unrestricted reserve figure. Tower received $166 million of MAP funds. We recognize that these funds provide some liquidity cushion for Tower in the near term; however, they ultimately must be gradually repaid beginning in April 2021, based on current regulations. Similarly, Tower had $55 million drawn on its short-term lines of credit as of the close of the year. We've excluded those draws from both our unrestricted reserve and debt figures under the assumption that they were for temporary working capital purposes. Subsequent to the end of the fiscal year, Tower paid down $25 million on its lines. Tower has agreements with four different banks for unsecured lines of credit with $90 million of total capacity. One additional committed $40 million facility exists to support SCHC's working capital needs. Combined with the organization's total unrestricted reserves and MAP funds, this provides some near-term mitigation to potential liquidity events, in our view. At June 30, 2020, Tower's unrestricted cash and investments (inclusive of MAP funds) were invested 48% in cash, 16% in fixed income, 21% in equities, and 15% in alternative investments. About 85% of the total unrestricted reserves was liquid within seven days.

We understand that management is updating its cash forecasts on a weekly basis. These forecasts were prepared in line with cash flow projections under the 2021 budget and include detailed sources and uses by month.

Debt-fueled acquisition and sizable losses have resulted in considerable leverage

Debt metrics are well below investment-grade medians and dropped further in 2020, due to a further decline in unrestricted net assets and a modest increase in debt as part of the February 2020 financings. The increase in debt was partly to provide permanent financing for Tower's share of the SCHC acquisition and for other capital. These transactions also materially de-risked Tower's debt portfolio through the elimination of its contingent liability debt, which included seven swaps and five bond issues under direct purchase agreements with four banks.

Tower no longer has liabilities with rating covenants and its sole financial covenant is the maintenance of at least 1.1x DSC.

Table 2

Tower Health--Financial Statistics

	--12 months ended June 30--	--Fiscal year ended June 30--			Medians for 'BBB-/BBB' rated health care systems	Medians for 'BBB+' rated health care systems
	2020	2019	2018	2017	2019	2019
Financial performance*						
Net patient revenue ($000s)	1,748,763	1,688,264	1,566,530	1,020,882	3,223,000	1,767,828
Total operating revenue ($000s)	1,923,423	1,753,728	1,620,948	1,052,356	4,003,663	2,034,197
Total operating expenses ($000s)	2,330,417	1,936,971	1,638,425	1,051,377	MNR	MNR
Operating income ($000s)	(406,994)	(183,243)	(17,477)	979	MNR	MNR
Operating margin (%)	(21.16)	(10.45)	(1.08)	0.09	(1.40)	(1.10)
Net nonoperating income ($000s)	42,484	46,622	121,084	29,199	MNR	MNR
Excess income ($000s)	(364,510)	(136,621)	103,607	30,178	MNR	MNR
Excess margin (%)	(18.54)	(7.59)	5.95	2.79	0.60	0.40
Operating EBIDA margin (%)	(13.38)	(2.42)	7.17	10.10	3.20	4.60
EBIDA margin (%)	(10.92)	0.24	13.63	12.53	5.10	5.70
Net available for debt service ($000s)	(214,775)	4,263	237,383	135,487	224,670	100,739
Maximum annual debt service ($000s)	90,722	90,722	90,722	90,722	MNR	MNR
Maximum annual debt service coverage (x)§	(2.37)	0.05	2.62	1.49	2.30	2.70
Operating lease-adjusted coverage (x)	(2.37)	0.31	2.25	1.43	2.00	2.10
Liquidity and financial flexibility						
Unrestricted reserves ($000s)	674,698	684,454	918,370	913,507	873,022	763,598
Unrestricted days' cash on hand	110.4	135.6	216.5	344.7	112.50	142.90
Unrestricted reserves/total long-term debt (%)	51.1	60.2	80.1	160.6	105.90	138.00
Unrestricted reserves/contingent liabilities (%)	N/A	372.5	496.1	412.4	792.10	828.90
Average age of plant (years)	12.8	11.8	11.1	11.6	11.10	11.30
Capital expenditures/depreciation and amortization (%)	75.5	166.4	96.3	135.3	142.00	81.20
Debt and liabilities						
Total long-term debt ($000s)	1,319,989	1,136,543	1,145,845	568,800	MNR	MNR
Long-term debt/capitalization (%)	78.4	60.1	55.1	39.7	53.00	35.00
Contingent liabilities ($000s)	0	183,723	185,101	221,496	MNR	MNR
Contingent liabilities/total long-term debt (%)	0.0	16.2	16.2	38.9	14.40	15.80
Debt burden (%)	4.61	5.04	5.21	8.39	2.10	1.90
Defined-benefit plan funded status (%)	N.A.	65.18	67.75	62.48	71.90	71.10
Miscellaneous						
Medicare advance payments ($000s)§	165,657	N/A	N/A	N/A	MNR	MNR
Short-term borrowings ($000s)†	55,000	17,802	0	0	MNR	MNR

Table 2

Tower Health--Financial Statistics (cont.)

	--12 months ended June 30--	--Fiscal year ended June 30--			Medians for 'BBB-/BBB' rated health care systems	Medians for 'BBB+' rated health care systems
	2020	2019	2018	2017	2019	2019
CARES Act grants recognized ($000s)	81,440	N/A	N/A	N/A	MNR	MNR
Risk based capital ratio (%)	N/A	N/A	N/A	N/A	MNR	MNR
Total net special funding ($000s)	55,414	46,327	46,316	9,771	MNR	MNR

N/A--Not applicable. N.A.--Not available. MNR--Median not reported. *Financial performance metrics include one-time costs of $30.4 million, $21.6 million, and $18.6 million for fiscal year 2020, fiscal year 2019, and fiscal year 2018, respectively. §MADS coverage in fiscal 2017 presented assuming total debt service of the new system, but cash flow only of the legacy Reading Health System. †Excluded from unrestricted reserves, long-term debt, and contingent liabilities.

Credit Snapshot

- Organization overview: Tower Health is a health system formed through the acquisition of five community hospitals by the former Reading Health System. On Oct. 1, 2017, Tower Health completed the acquisition of five former CHS hospitals, transforming it into one of the larger health care systems in Pennsylvania. The five acquired hospitals are Brandywine Hospital in Coatesville, Chestnut Hill Hospital in Philadelphia, Jennersville Regional Hospital in West Grove, Phoenixville Hospital in Phoenixville, and Pottstown Memorial Medical Center in Pottstown. The organization now consists of seven hospitals following the acquisition of SCHC in January 2020. Tower Health also includes a JV inpatient behavioral health facility and numerous ambulatory sites in southeastern Pennsylvania
- Security pledge: The obligated group's gross revenue pledge secures the bonds outstanding. The obligated group constitutes approximately 78% and 97% of the overall system's total revenues and assets, respectively, as of the unaudited year ended June 30, 2020
- Group rating methodology: The rating reflects our view of Tower Health's group credit profile and the obligated group's core status. Accordingly, the rating is at the level of the group credit profile. The obligated group consists of Tower Health, Reading Hospital, Brandywine Hospital, Chestnut Hill Hospital, Jennersville Regional Hospital, Phoenixville Hospital, and Pottstown Memorial Medical Center

Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Ratings Detail (As Of October 30, 2020)

Tower Hlth rev bnds ser 2020 due 11/01/2051

Long Term Rating	BB+/Negative	Downgraded

Berks Cnty Indl Dev Auth, Pennsylvania

Tower Hlth, Pennsylvania

Berks Cnty Indl Dev Auth (Tower Hlth) hlth sys rev bnds (Tower Hlth) ser 2017 due 11/01/2047

Ratings Detail (As Of October 30, 2020) (cont.)		
Long Term Rating	BB+/Negative	Downgraded
Berks Cnty Indl Dev Auth (Tower Hlth) sys (AGM) (SECMKT)		
Unenhanced Rating	BB+(SPUR)/Negative	Downgraded
Berks Cnty Mun Auth, Pennsylvania		
Tower Hlth, Pennsylvania		
Berks Cnty Mun Auth rev bnds (Tower Hlth)		
Long Term Rating	BB+/Negative	Downgraded
Berks Cnty Mun Auth rev bnds (Tower Hlth)		
Long Term Rating	BB+/Negative	Downgraded
Many issues are enhanced by bond insurance.		