

# The Capital Markets and the New Economy: 2010 Best Practice Repositioning Actions



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***KaufmanHall***

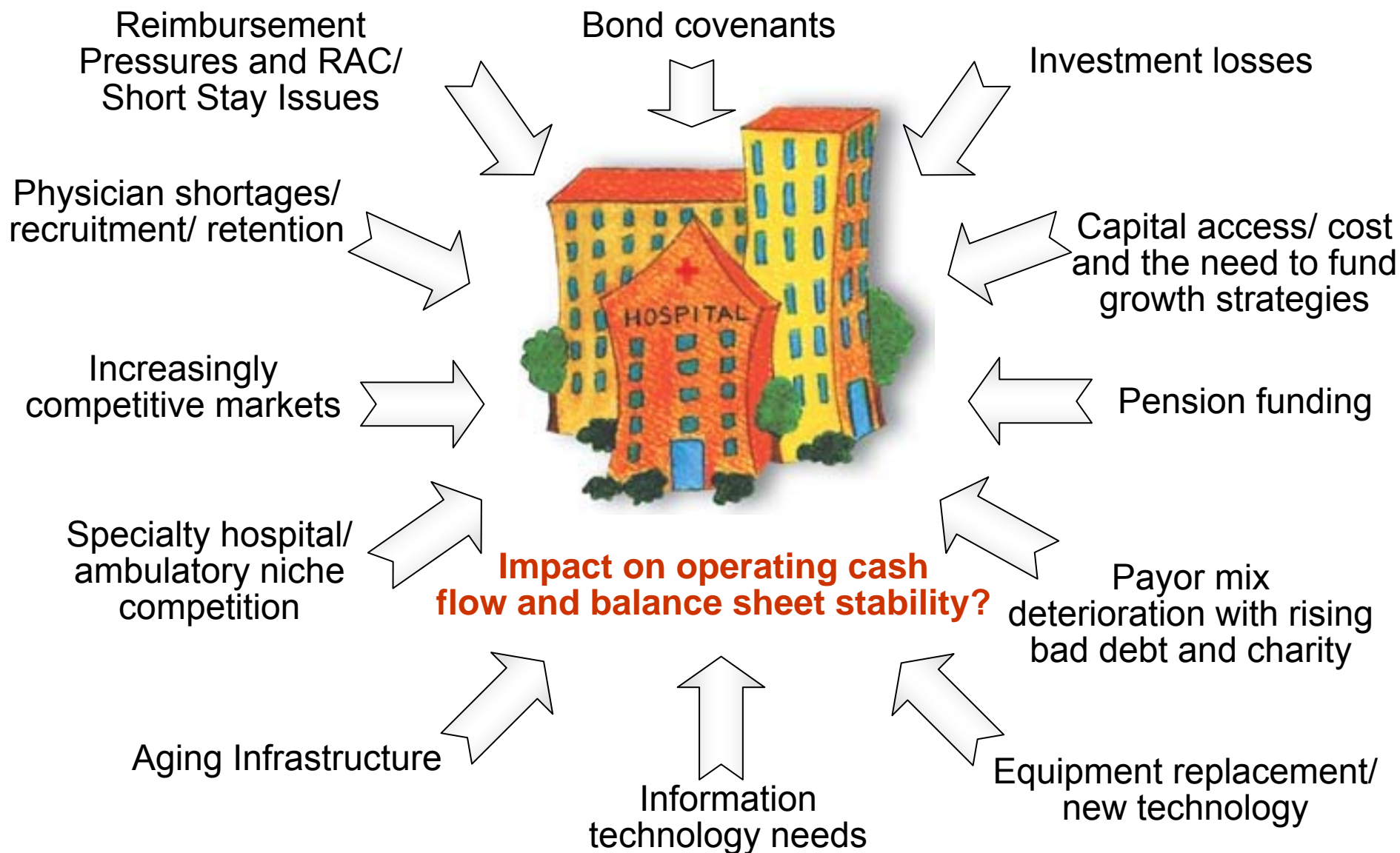
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## Agenda

- Current Market Environment and Industry Trends
- Capital Markets Update
- How Are Top Performing Providers Responding?
- Final Thoughts
- Questions

# Current Market Environment and Industry Trends

## Feeling Squeezed Even Before the Impact of Healthcare Reform?



## Pre-Healthcare Reform the Industry Has Already Experienced ...

### ***Significantly Strained Operating Performance***

1. Decreased volume – especially outpatient services and surgery
2. Bad debt/ charity care increases
3. Increased interest expense
4. Threatened state and federal cost containment efforts

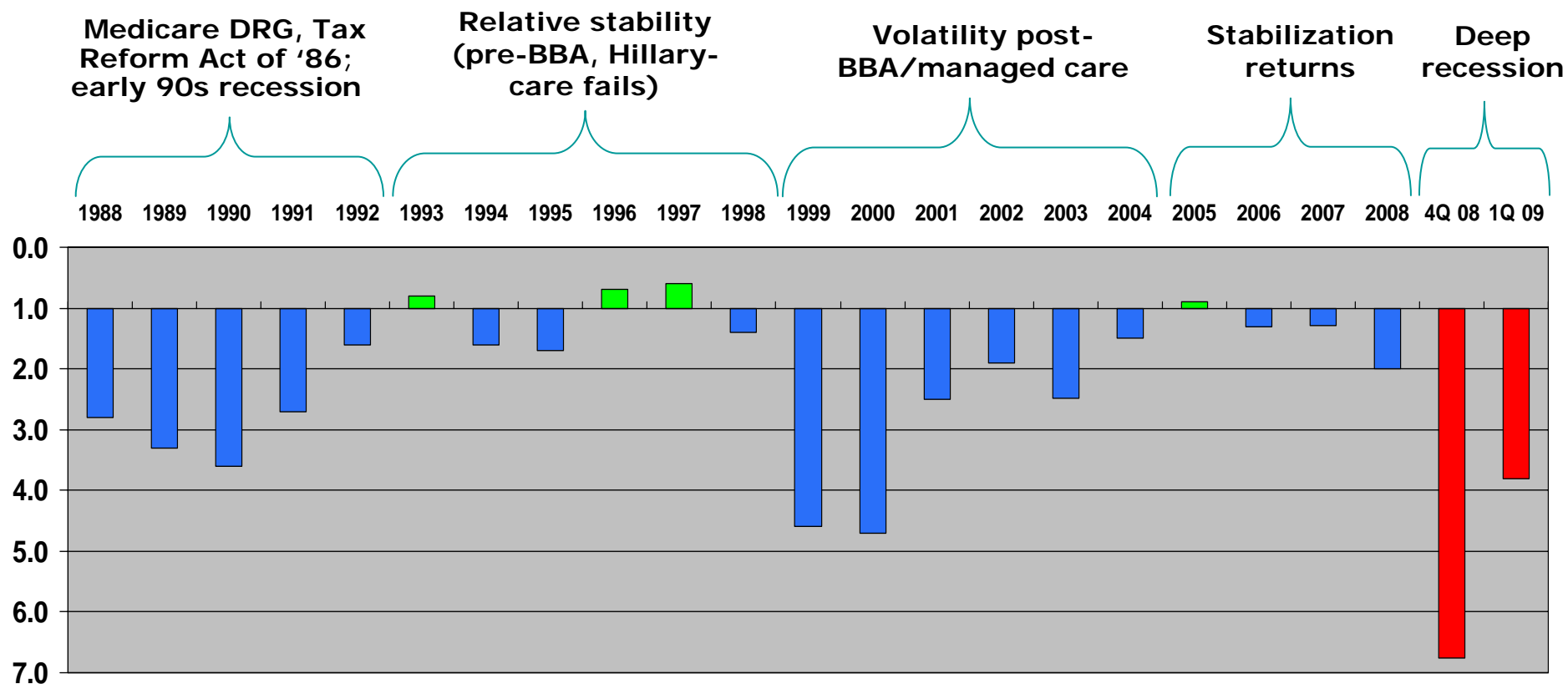
### ***Considerable Pressure on Liquidity***

1. Cash and investments losses
2. Pension funding
3. Swap mark-to-market and collateral posting
4. Reduced operating performance

### ***Competitive Capital Needs Continuing to Outweigh Available Resources***

1. Physician alignment strategies: employment, joint ventures, etc.
2. Aging facilities, obsolete care configurations and capacity constraints
3. IT requirements and increasingly costly technology
4. Growth, scale and market consolidation initiatives

## Not-for-Profit Healthcare Ratio of Credit Rating Downgrades to Upgrades Depicts a 20-Year Trend of Cyclical Volatility



**Downgrades outpaced upgrades in 16 out of the last 20 years**

Source: Chart from Moody's Investors Service, April 2009.

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## December 2008 Medians Highlight Market Downturn

|  | Dec 2008<br>Year End | 2008    | 2007    | 2006    |
|--|----------------------|---------|---------|---------|
| Sample Size  | 165                  | 532     | 566     | 556     |
| <u>Statement of operations</u>                     |                      |         |         |         |
| Net patient revenue                                | 429,157              | 358,773 | 311,196 | 269,005 |
| MADS coverage                                      | 2.5                  | 3.1     | 4.0     | 3.9     |
| Max debt service/ total revenue (%) (debt burden)  | 3.2                  | 3.2     | 3.0     | 3.2     |
| EBIDA (\$000)                                      | 32,932               | 34,323  | 41,254  | 35,839  |
| Non-operating revenue/ total revenue (%)           | 0.0                  | 1.6     | 3.0     | 2.4     |
| EBIDA margin (%)                                   | 7.8                  | 9.8     | 12.2    | 12.0    |
| Operating margin (%)                               | 1.8                  | 1.8     | 2.5     | 2.9     |
| Excess margin (%)                                  | 1.2                  | 3.0     | 5.6     | 5.3     |
| Capital exp/ depreciation and amortization exp (%) | 158.3                | 156.1   | 151.6   | 145.3   |
| <u>Balance sheet</u>                               |                      |         |         |         |
| Average age of plant (years)                       | 9.8                  | 9.8     | 9.7     | 9.6     |
| Days cash on hand                                  | 134.0                | 145.9   | 167.4   | 162.2   |
| Days in accounts receivable                        | 47.5                 | 48.4    | 49.3    | 49.9    |
| Cash flow/ total liabilities (%)                   | 9.4                  | 13.7    | 18.9    | 18.1    |
| Unrestricted cash/ long-term debt (%)              | 89.4                 | 104.6   | 115.8   | 108.4   |

Notes: Source: Standard & Poor's. Medians are for all rated hospitals and health systems. 2008 column includes all 2008 fiscal year ends. December 2008 Year End column includes only December 31, 2008 results.

## All Three Rating Agencies Have a Negative Industry Outlook

### Fitch Ratings:

“On Jan. 29, 2009, Fitch affirmed its negative rating outlook on the nonprofit acute care sector...reflecting **a weakened credit environment characterized by constrained access to capital, deteriorating payor mix, lower patient volumes, elevated interest rates, and severe investment losses.** Fitch anticipates that many of these pressures will continue to exert varying levels of stress over the near term and, **over the next 12 to 24 months, downgrades will exceed upgrades, although with affirmations remaining the most common rating action.**....Fitch expects greater rating pressure on the lower end of the rating spectrum, as ‘BBB’ category hospitals have a thinner financial cushion and fewer credit strengths, such as geographic diversity, specialty services, strong payor mixes, or leading market shares, to sustain them through the current economic downturn, compared with ‘AA’ and ‘A’ category hospitals.”

### Moody's:

“Moody’s fiscal year (FY) 2008 not-for-profit hospital medians show a weakening of credit measures across all major ratios and all broad rating categories. Moody’s revised its outlook for the not-for-profit hospital sector to negative from stable in November 2008....Primary reasons for the revision of the sector outlook were the tightening of credit markets, expected broad based weakening in hospital operating performance, declining liquidity, softer volumes, and a worsening payer mix. ....**The weakening of balance sheets was one of the most significant credit developments in 2008.** While investment losses were most pronounced in the fourth quarter of calendar year 2008, the majority of organizations experienced a loss in liquidity regardless of their fiscal year end date....**Looking forward, we expect that in 2009 operating measures will continue to come under pressure. Volume growth is likely to continue to be modest, revenue growth is at historically low levels, and hospitals will continue to search for ways to keep expense growth similarly low.**”

### Standard & Poor's:

Fiscal 2008 key median ratios for U.S. stand-alone hospitals deteriorated across all rating categories and resulted in 60 downgrades by Standard & Poor's Ratings.... In our view...unfavorable results were partially related to the slowdown of the U.S. economy coupled with the fall of the investment markets, although we believe that many core operating challenges were present before 2008, and the recession merely exacerbated the declines.... **We believe this highlights the importance that we place on qualitative measures such as business position, the competitiveness of the service areas, the quality and effectiveness of the board and senior management, local demographic and economic trends, risks associated with the medical staff size, third-party payor contracting, local and national regulatory environments, and future capital plans.**

(1) Source: Fitch Ratings *2009 Median Ratios for Nonprofit Hospitals and Healthcare Systems* - August 7, 2009.

(2) Source: Moody's *Not-for-Profit Healthcare Medians for Fiscal Year 2008 Show Weakening Across All Major Ratios and All Rating Categories* - August 2009.

(3) Source: Standard & Poor's *U.S. Not-For-Profit Health Care Stand-Alone Fiscal 2008 Median Ratios Weaken Across The Board* - July 7, 2009.

## Key Themes from Negative Industry Outlooks

1. Access to capital is materially impaired and more costly
2. Variable rate debt structures and swaps add considerable risk
3. Investment portfolio losses are adversely impacting cash flow and cash, resulting in weakened balance sheets and less financial flexibility
4. Pension funding is a major financial concern for those with defined benefit programs (i.e., current market value ↓, discount rate ↓, earnings rate ↓)
5. Physician employment strategies are increasingly more important and prevalent, but are creating more demands on finite liquidity
6. Economic recession is reducing utilization and adversely impacting payor mix and bad debt
7. Expect more industry consolidation as the credit gap widens
8. More capital plans will need to go back to the drawing board given all of the above
9. Good management and governance now even more important

## Rating Agency Perspective Implications

- Negative rating agency outlook and increasing downgrade-to-upgrade ratio a continued concern to potential investors and credit enhancers
  - Further impact on market access, costs, covenants, and security provisions
- New emphasis on capital structure and investment portfolio event risk
  - Debt: variable interest rate volatility and put risk
  - Enhancers: rating, terms, LOC renewability, bank ability to fund a put, etc.
  - Investment portfolio: risk, returns, hedge fund investment liquidity, etc.
  - Documents: “springing” and default covenant trigger levels, etc.
- Heightened review of audit footnotes: off balance sheet structures, guarantees, operating leases, derivatives, etc.
  - “Off balance sheet” ≠ “off credit”
- Consistency, predictability, market position, management team accountability/ effectiveness, and balance sheet management continue to be key to credit
  - “Remember last meeting when you said . . .”
  - “Show me five years of operating budgets versus audited actual”
- Improved communication and forthright accurate disclosure are essential

## What Are a Hospital's "Sources and Uses" of Liquidity?

### Uses of liquidity

- Variable-rate debt and put obligations
- Swap termination/ collateral posting
- Alternative investment capital commitments
- Capital projects underway
- Pension requirements
- Working capital

### Sources of liquidity

- Cash and investments (within one week, one year, and beyond)
- Other investments that can be liquidated within a year
- Bank lines of credit
- Cash flow
- Working capital

## New Enhanced Ratios to Be Developed

### – Traditional Ratios to Remain in Place

- Analysis of relative liquidity compared to absolute unrestricted cash and investments
  - Percentage of unrestricted cash and investments that is available within one week, one year, and beyond one year
- Analysis of demands on annual liquidity
  - Capital expenditures
  - Pension funding
  - Debt service
  - Puttable debt, bank lines, commercial paper
  - Maintenance of sufficient (liquid) days cash on hand

## Moody's Minimum Performance Benchmarks: New Ratios and Near-term Expectation Levels

|                                   | <b>AA/Aa</b>    | <b>A</b>          | <b>BBB/Baa</b>    |
|-----------------------------------|-----------------|-------------------|-------------------|
| <b>Patient Volume</b>             | Growing or flat | Declines up to 2% | Declines up to 4% |
| <b>Net Patient Revenue Growth</b> | > 4%            | > 2%              | Flat              |
| <b>Operating Cash Flow Margin</b> | > 9%            | > 7.5%            | > 6%              |
| <b>Days Cash on Hand</b>          | > 190 days      | > 115 days        | > 90 days         |
| <b>Cash to Debt</b>               | > 140%          | > 80%             | > 55%             |
| <b>Variable Rate Debt Level</b>   | < 50%           | < 35%             | < 20%             |
| <b>Cash to Puttable Debt</b>      | > 150%          | > 90%             | > 70%             |
| <b>Covenant Level Clearance</b>   | > 55%           | > 40%             | > 25%             |

Source: Moody's U.S. Public Finance – Not-for-Profit Healthcare Rating Roadmap:  
Hospitals Under Stress, but Strong Management and Federal Stimulus May Mitigate Risks.

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## Moody's Investors Service Recently Released Rating Roadmap

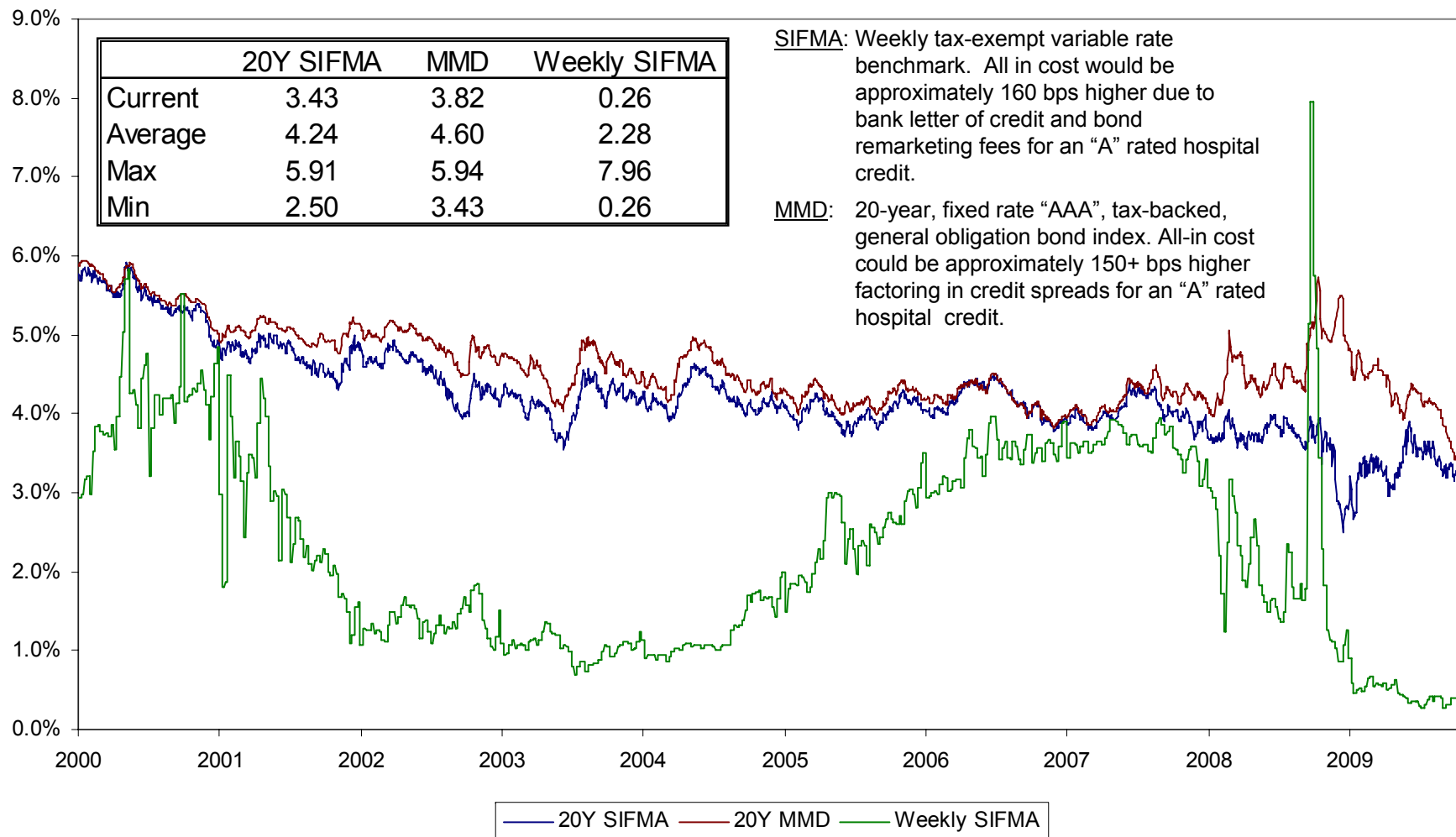
- Moody's released a new report in April 2009 to specifically address their rating methodology during market turmoil
- The four key factors identified by Moody's are: (1) weaker market demand and declining cash flow margins; (2) investment losses and weaker balance sheets; (3) debt structure and liquidity stress; and (4) market access problems
- These risk factors are offset by two risk mitigants: (1) management and governance actions; and (2) Federal government stimulus

| Recession and Credit Market Risks: Health Care Rating Guidance |  |  |   |  |  |   |   |                                     |   |   |
|--|--|--|---|--|--|---|---|-------------------------------------|---|---|
| Rating Category  | Weaker Market Demand and Declining Cash Flow Margins   |  | Investment Losses and Weaker Balance Sheet              | Debt Structure and Liquidity Stress  |  | Market Access Problems                          |   | Management and Governance Actions   | Federal Government Actions  |   |
| Aa   | Patient volume still growing or flat; net patient revenue growth at least 4%; bad debt expense growth no more than 30%                 | Operating Cash Flow Margin at least 9.0% | Days Cash at least 190 days; Cash-to-Debt at least 140% | Significant head-room under bank and swap covenants (at least 55% clearance); strong diversification of investment managers and funds, banks and counterparties          |  | Unrestricted Cash-to-Putable-Debt at least 150% | Viable market access still assured although at elevated spreads | No more than 50% variable rate debt | <p>(1) NEAR-TERM ACTIONS: Evidence of operational, capital and liquidity decisions to mitigate effects of downturn even if impairment of cash flow or liquidity has not fully materialized yet, including establishing operating lines of credit with banks, restructuring debt structures, reducing or abating large capital projects to conserve cash.</p> <p>(2) LONG-TERM ACTIONS AND BOARD SUPPORT: Evidence that management and board agree to take defensive actions if needed; including changes in strategic plans for possible M&amp;A, capital program, compensation, staffing and clinical services; also including revisiting of investment allocation; consideration to change benefit pension plan</p> | <p>(1) STIMULUS PROGRAM: Stimulus Act is expected to help most hospitals in short-term to some degree through grants for information technology and expansion of COBRA insurance for unemployed; urban safety-net hospitals, children's hospitals, academic medical center likely to see greatest benefit given higher Medicaid and charity care</p> <p>(2) HEALTH CARE REFORM: Likely will provide broader healthcare coverage for previously uninsured although may come at the expense of more stringent Medicare reimbursement compliance and possibly lower profitability for each procedure as costs rise</p> |
| A  | Patient volume declines limited to no more than 2%; net patient revenue growth at least 2%; bad debt expense growth no more than 15%   | Operating Cash Flow Margin at least 7.5% | Days Cash at least 115 days; Cash-to-Debt at least 80%  | Significant headroom under bank and swap covenants (at least 40% clearance); strong diversification of investment managers and funds, banks and counterparties           |  | Unrestricted Cash-to-Putable-Debt at least 90%  | Strained but still viable market access at much higher spreads  | No more than 35% variable rate debt |   |   |
| Baa  | Patient volume declines limited to no more than 4%; net patient revenue growth at least flat; bad debt expense growth no more than 10% | Operating Cash Flow Margin at least 6.0% | Days Cash at least 90 days; Cash-to-Debt at least 55%   | Headroom under bank and swap covenants narrowing (at least 25% clearance); moderate to strong diversification of investment managers and funds, banks and counterparties |  | Unrestricted Cash-to-puttable Debt at least 70% | Limited or no market access to capital                          | No more than 20% variable rate debt |   |   |

# Capital Markets Update

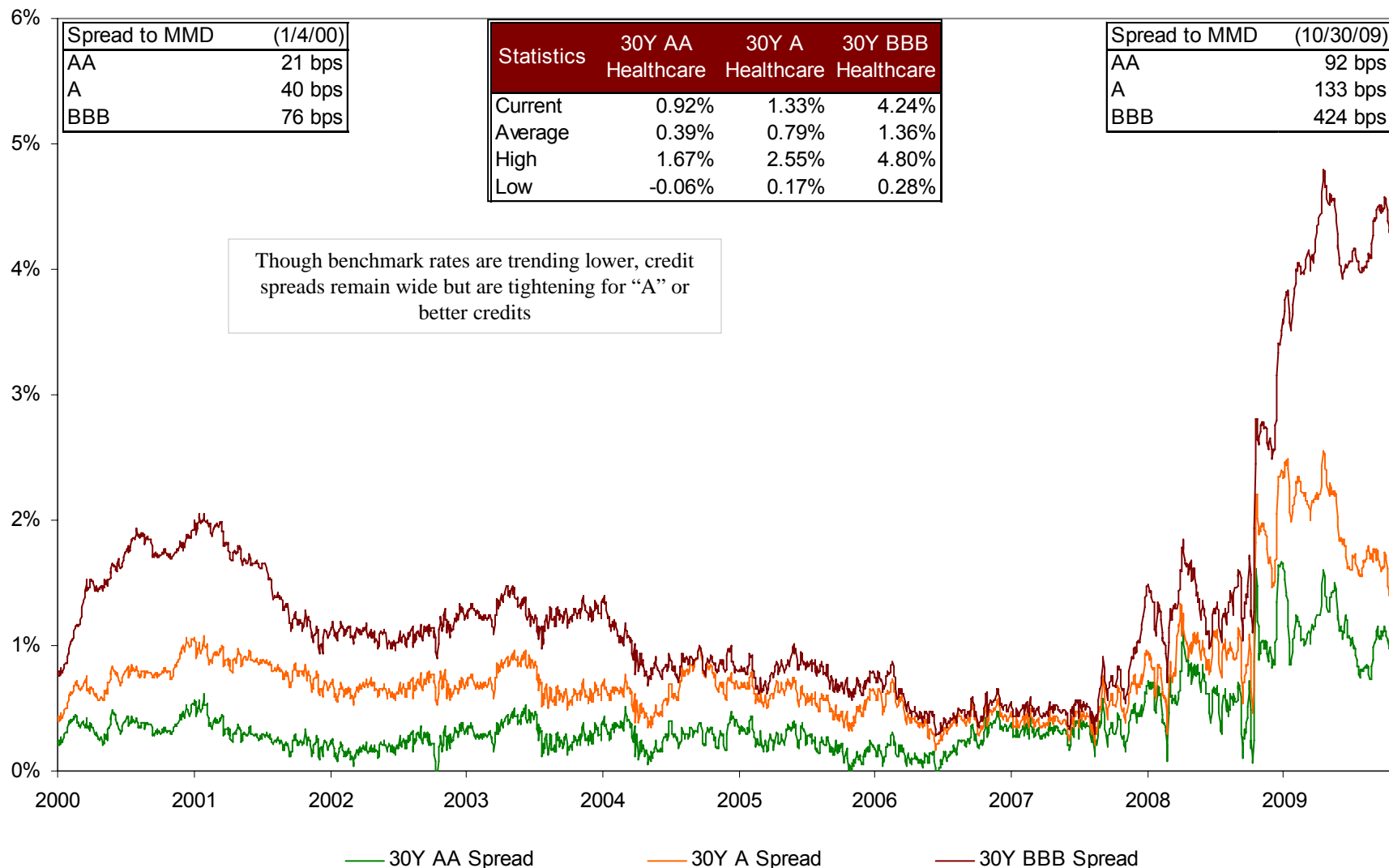
# Tax-exempt Market Benchmark Indices

Trend of Tax-Exempt Rates



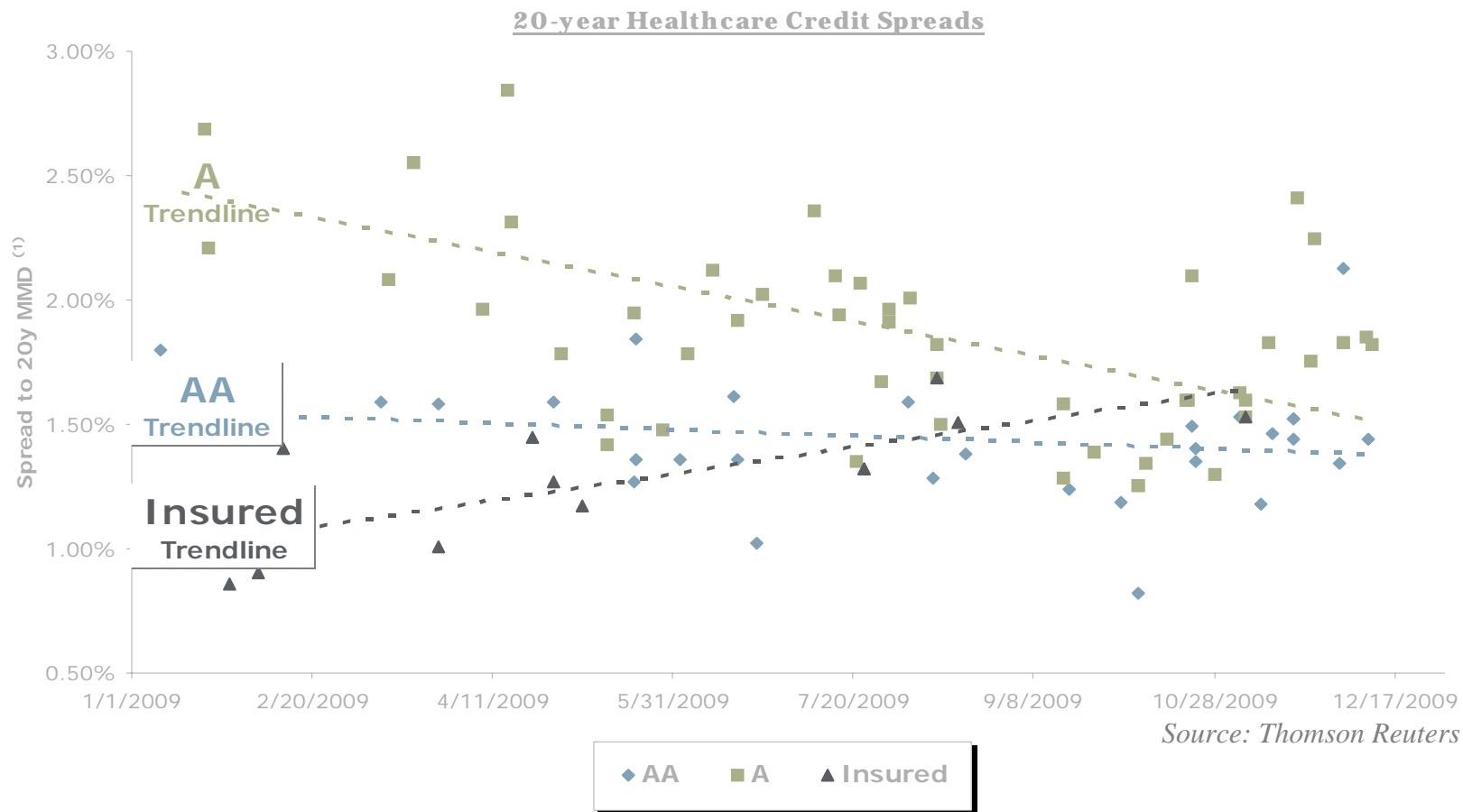
# Healthcare Credit Spreads Are Well Above Average

'AA', 'A', and 'BBB' Healthcare Credit Spreads over MMD 'AAA' Index



# Healthcare Credit Spreads During 2009

## Rally In Credit Spreads Across Higher Rated (AA – A) Healthcare Institutions



- The municipal bond market for healthcare borrowers has improved, as demonstrated by compressing credit spreads, but investors remain credit sensitive
- Following insurers' credit declines, insurers' credit became more closely scrutinized by investors

(1) MMD - Municipal Market Data Index is widely recognized as the source of benchmark municipal bond data and thus, commonly used as the benchmark for municipal yields across the credit spectrum.

(2) Source: Wells Fargo Bank

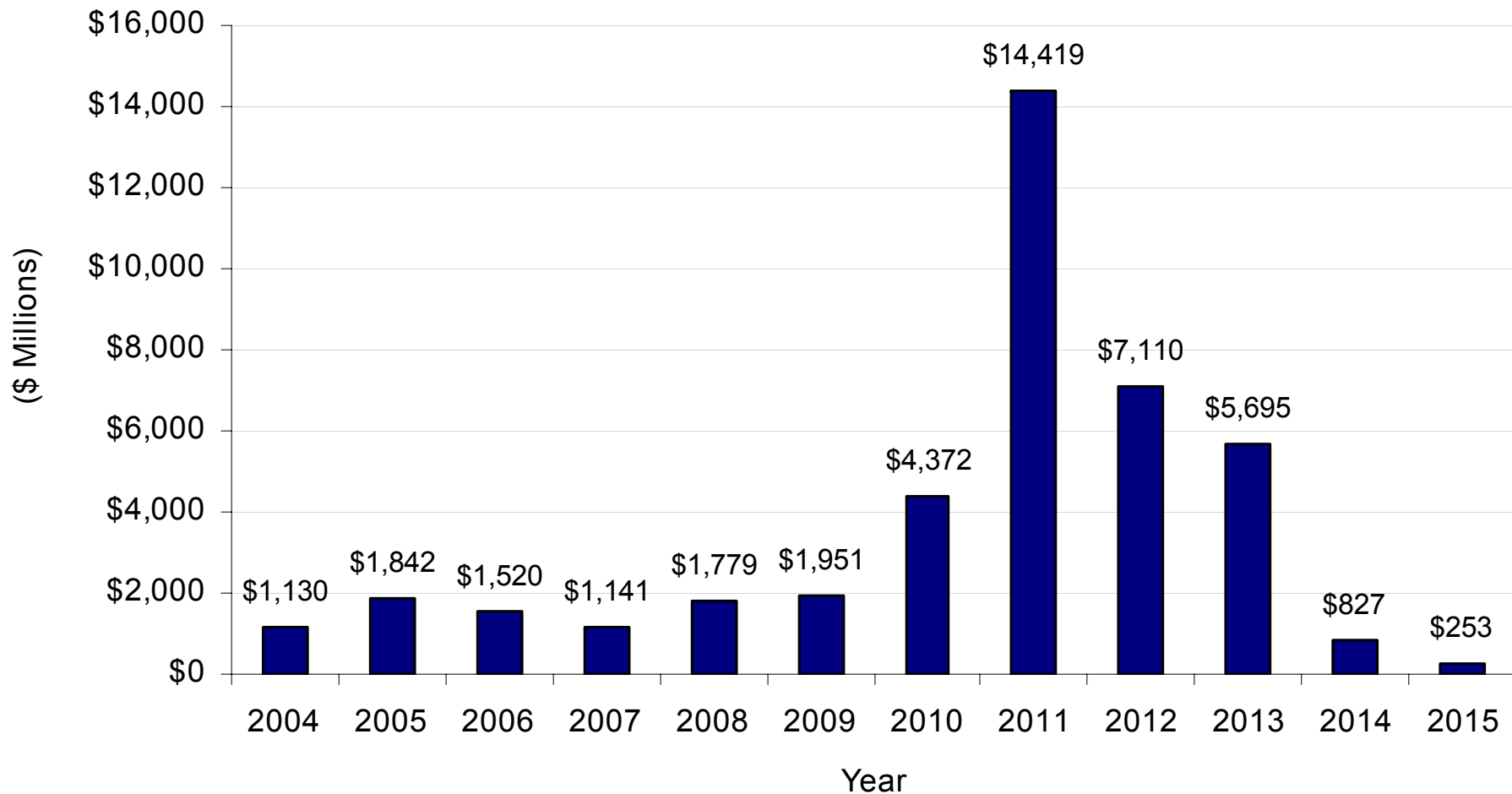
## Fixed-Rate Market Performance

- Significant improvement in both rates and relative value
  - MMD to 68% LIBOR spread nearing historic averages
- Falling rate environment has obvious benefits, but relative value realignment is equally important
  - Improves the cost/ benefit metrics associated with restructuring synthetic fixed with natural fixed
    - ✓ Low LIBOR rates mean cost of de-risking is high (swap termination payments), but low MMD provides an offset
    - ✓ Net cost is dependent on credit charges (both bank costs to remain floating and investor costs to sell fixed) and risk assessment attached to floating-rate portfolio
- Risks going forward: market shocks (rate or credit) that shift investor dollars out of municipals or out of long-term bonds to equities or money markets

## Credit Environment – Intermediaries

- Bond insurance: essentially one player (Financial Security Assurance, Inc./ Assured Guaranty)
  - Can add value in lower credit situations – but not a full credit transfer (buyers will look through to the underlying credit)
- Commercial banks: little to no credit-only activity
  - Credit remains tight and concentrated on (1) higher-grade underlying credits and/or (2) relationships
    - ✓ Hearing about re-emergence of some credit-only banks, but limited and highly selective
  - Credit remains relatively expensive
    - ✓ 3-year “A” category letter of credit (LOC) ranging from 1.25% to 1.50%
  - Major concern will be the renewal sequences that start in 2010 and 2011
    - ✓ Fundamentally different market and capital structure risk

### LOC Expirations/Renewals 2004 to 2015



Source: Citigroup based on their review of Thomson Reuters SDC data; sample of 1,079 healthcare VRDO programs backed by a Letter of Credit as of 10/05/2009. For illustration purposes only.

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## Credit Environment – Bonds

- General improvement in market access and credit spreads throughout 2009
  1. Retail support for high-grade securities
  2. Build America Bond program removes huge amounts of general municipal supply – more dollars chase fewer new-issue bonds
  3. Rates fall, pulling even more dollars in pursuit of yield paper (including healthcare)
  4. Investor reallocation out of money markets into long-term bond funds
- Access is improving down the credit curve, but relative costs remain high
- Volatility or risks going forward
  - Sector saturation – investors start to get “full up” on allocation to healthcare
  - Default in the municipal market or worse in the healthcare market
  - Ending of Build America Bond program
  - Increases in benchmark (Treasury) rates due to massive supply

## Capital Markets Improved in 2009, but Uncertainties Remain

1. Market volatility has settled down with access, costs and terms highly dependent on credit rating
  - Approx. 30-year fixed rates: “AA” at 5.5%+, “A” at 5.85%+, “BBB” at 6.5%+
  - LOC fees: “AA” at 110+ bps, “A” at 130+ bps, “BBB” uncertain access
  - More restrictive terms depending on credit rating (mortgage, reserve fund, days cash around 75 days, 1.25x coverage, etc.)
2. Variable rate debt remains very low cost (<0.5%) since January, but the bank LOC market is more difficult and product risks abound
  - Bank downgrade, bank pricing/ covenants, LOC renewal, bond put, etc.
3. Unsettling near-term potential wild cards
  1. Pronounced inflation expectation
  2. Further bank industry collapse (e.g., commercial real estate, credit card debt, etc.)
  3. Severe capital markets dislocation/ further liquidity crises
  4. Health care industry reform
  5. Large-scale hospital bankruptcy announcement (e.g., AHERF in the 90s)
  6. Over supply of new fixed rate issues (already happening)
  7. More confidence in equities, real estate or commodities shifting money out of bonds

## Long-Term, Fixed-Rate Investors Remain Cautious

- **Underlying credit/ market fundamentals matter most, so expect to speak with buyers more diligently looking for highly rated, well-positioned, long-term market winning borrowers**
  - Extended pre-marketing period (full one to two weeks)
  - Investor calls and possibly in-person investor meetings/ road shows, depending on credit
  - Heightened review of Appendix A and credit reports
- **Expect a buyer's market with a lot of supply – now is not the time to cut corners and push the edge on security, structure, covenants, and disclosure**
  - Security structure expectations
    - ✓ Revenue pledge a given for all credits
    - ✓ Mortgages for most “A” and lower credits (plan ahead, this takes time)
    - ✓ Debt service reserve funding for nearly all “A” category and lower credits
  - Covenants and structuring matter a lot more to fixed rate investors
    - ✓ Liquidity covenant and periodic use of capitalization covenant
    - ✓ Tightening thresholds for additional debt, asset disposition, senior liens, etc.
    - ✓ Parity with existing commercial bank LOC and insurer covenants an emerging trend (be prepared to address this head-on during investor calls)
  - Disclosure matters
    - ✓ 45 to 60 days quarterly (yes, all 4 quarters) and 120 to 150 days audit
    - ✓ Direct obligation to investors with disclosure

## Short-Term, Variable Rate Investors Continue to Step Up...For Now

- **Large money market funds, the primary buyers of this debt, have invested in a lot of supply across the country since the auction rate/ insurer meltdown**
- **VRDBs supported by “good banks” are very attractive**
  - “Good banks” not only have the highest ratings (perceived staying power) and are not overexposed in the LOC market
  - The best of the “good banks” typically have long-term “AA” category and short-term ratings as follows: Moody’s: “VMIG-1”, S&P: “A-1+”, “A-1”, Fitch Ratings: “F-1+”, “F-1”
  - Monitor long-term and short-term ratings carefully – many banks have either been downgraded, have negative outlooks, or are on credit watch negative
- **Documentation/ structuring details under heightened review**
  - What exactly happens if the remarketing agent resigns or goes out of business and a replacement can’t be found?
  - What exactly happens if the bonds are put and the bank can’t cover?
  - How close is the borrower to a downgrade triggering LOC termination?
- **Key Concern: How long will investors accept short-term, tax-exempt, money market funds yielding under 0.3% vs. moving into other higher yielding investment opportunities (equities, real estate, commodities, etc.)?**

## Access to Bank Letters of Credit Remains Good

- **For borrowers considering letters and lines of credit, expect:**
  - Current relationship bank(s), if highly rated, will likely be your best partner (one-off lenders to non-comprehensive clients are very infrequent)
  - Less capacity for any one borrower (generally \$50 to \$85 million for a stand-alone hospital, perhaps more for systems and highly rated stand-alone hospitals)
    - ✓ Bank syndication available on a “best efforts” basis, but more complicated and costly
    - ✓ Higher pricing
    - ✓ Shorter renewal cycles (364-day to 3 years)
    - ✓ Annual evergreen renewal provisions very helpful
    - ✓ Insist on “real” term-out provisions in the event of a remarketing failure – 3 to 5 years
  - Restrictive and highly negotiated covenants, security, and termination provisions
    - ✓ Be mindful of insurer (e.g., “AA-”) and borrower rating (e.g., “A-”) downgrade termination triggers
  - Possible subjective consent provisions (e.g., issuing new debt, asset disposition, mergers, joint ventures, sale lease back transactions, etc.)
  - Tie-in with other banking services (e.g., commercial business account management, investment management, and other fee-generating services)

## A Reminder of Primary Variable Rate Demand Note Risks

| Risk   | Mitigating factors  | Options   |
|--|---|---|
| <b>Interest rate increase</b>                              | <ul style="list-style-type: none"> <li>Fixed payor swaps, if in place, may act as a hedge against general rate inflation via short-term LIBOR assuming a correlation is maintained</li> <li>Portfolio returns on any short-term/ fixed-income investments</li> </ul>                      | <ul style="list-style-type: none"> <li>Stay the course</li> <li>Refinance to fixed (more expensive)</li> <li>Cash prepayment</li> </ul>                               |
| <b>Tax rates decline</b>                                   | <ul style="list-style-type: none"> <li>None, but seems very unlikely in the near term</li> </ul>  | <ul style="list-style-type: none"> <li>Stay the course</li> <li>Refinance to fixed (more expensive)</li> <li>Cash prepayment</li> </ul>                               |
| <b>Healthcare industry risks</b>                           | <ul style="list-style-type: none"> <li>Bank LOC enhancement will shield most, but not all, of the interest rate risk (however, healthcare industry risks may affect cost or availability of the bank LOC)</li> </ul>  | <ul style="list-style-type: none"> <li>Stay the course</li> <li>Refinance to fixed (more expensive)</li> <li>Cash prepayment</li> </ul>                               |
| <b>Borrower credit downgrade</b>                           | <ul style="list-style-type: none"> <li>Bank LOC usually okay if Borrower is at least mid “A” category or higher (will affect pricing and availability, though)</li> </ul>   | <ul style="list-style-type: none"> <li>Stay the course</li> <li>Refinance to fixed (more expensive)</li> <li>Cash prepayment</li> </ul>                               |
| <b>Bank downgrade</b>                                      | <ul style="list-style-type: none"> <li>Use highly rated banks</li> <li>Ability to replace LOC provider if alternates exist</li> </ul>   | <ul style="list-style-type: none"> <li>Stay the course</li> <li>Refinance to fixed (more expensive)</li> <li>Cash prepayment</li> <li>Replace LOC provider</li> </ul> |
| <b>Bank LOC renewal</b>                                    | <ul style="list-style-type: none"> <li>Maintenance of Borrower’s credit rating in the “A” category or better</li> <li>Use relationship bank</li> <li>Ability to replace LOC provider</li> <li>Add “evergreen” provisions or longer-dated renewal terms (3 years, if available)</li> </ul> | <ul style="list-style-type: none"> <li>Stay the course</li> <li>Refinance to fixed (more expensive)</li> <li>Cash prepayment</li> <li>Replace LOC provider</li> </ul> |
| <b>VRDN market demand/ supply concerns and dislocation</b> | <ul style="list-style-type: none"> <li>Historical stability/ marketability of VRDN market up until now</li> <li>VRDNs have traded very well over the last 17 years at an average of 3.09% with a range of 0.27% to 7.89%</li> </ul>   | <ul style="list-style-type: none"> <li>Stay the course</li> <li>Refinance to fixed (more expensive)</li> <li>Cash prepayment</li> </ul>                               |
| <b>Failed debt remarketing (bank put)</b>                  | <ul style="list-style-type: none"> <li>Bank term out provides time to fix (depending on the course of the put – bank, market, remarketing agent, etc.)</li> </ul>   | <ul style="list-style-type: none"> <li>Stay the course</li> <li>Refinance to fixed (more expensive)</li> <li>Cash prepayment</li> <li>Replace LOC provider</li> </ul> |
| <b>Inability of bank to fund a bond put</b>                | <ul style="list-style-type: none"> <li>Check documents for provisions and procedures as to whether this is an event of default</li> </ul>   | <ul style="list-style-type: none"> <li>Refinance to fixed (more expensive)</li> <li>Cash prepayment</li> <li>Replace LOC provider</li> </ul>                          |

**Additionally, rating agencies have expressed considerable “event risk” concern**

# How Are Top Performing Providers Responding to the Current Environment?

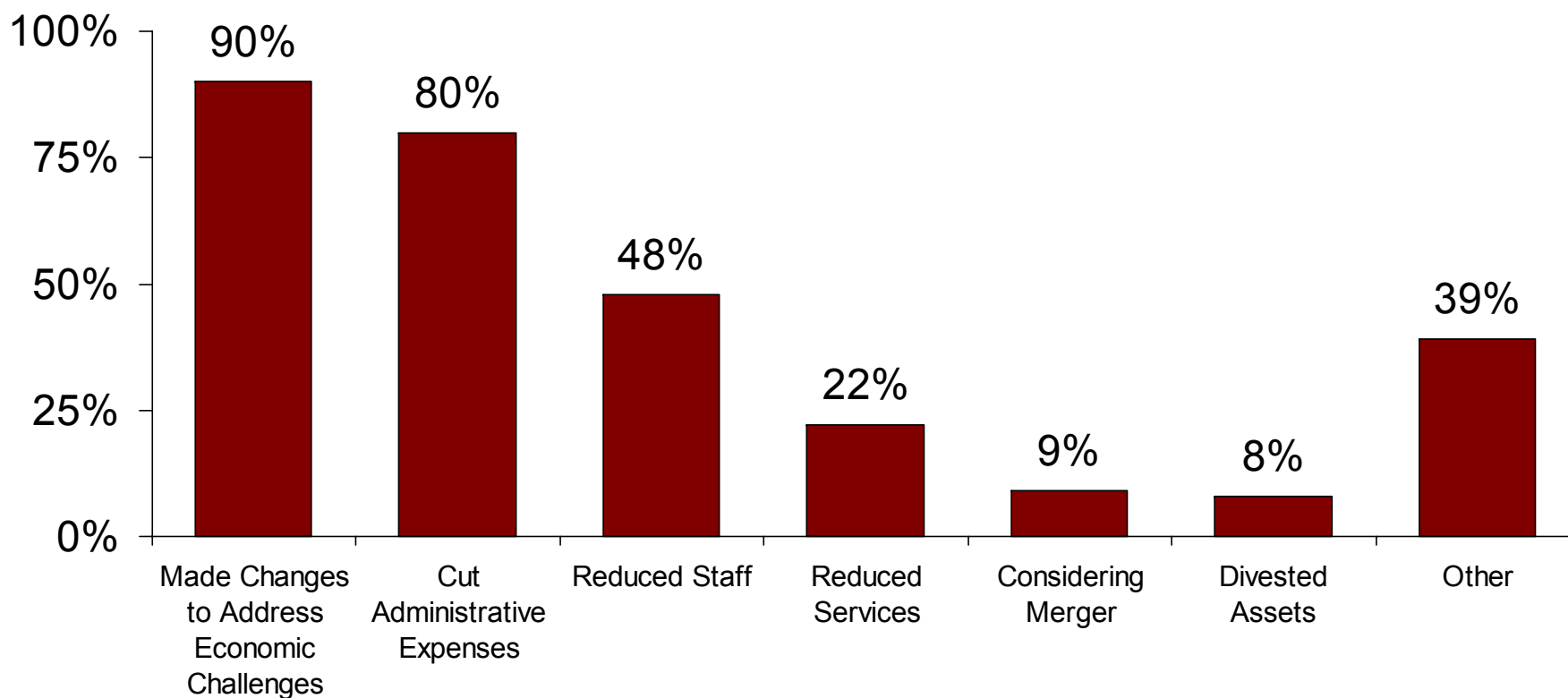
## Back to Business Basics

This means...

- ... Real business plans emphasizing profitable growth while balancing strategic investment with financial capability
- ... Financial results that measure up to budget and previous forecasts
- ... Considerable attention to expense control and revenue enhancement
- ... Consolidation and management of services
- ... Allocation of capital that equals “real measures” of capital capacity
- ... Vigilant attention to reimbursement trends and healthcare reform

## Nearly All Hospitals Are Making Changes to Address Current and Expected Economic Challenges

Percent of Hospitals Making Changes in Response to Economic Concerns Since September 2008

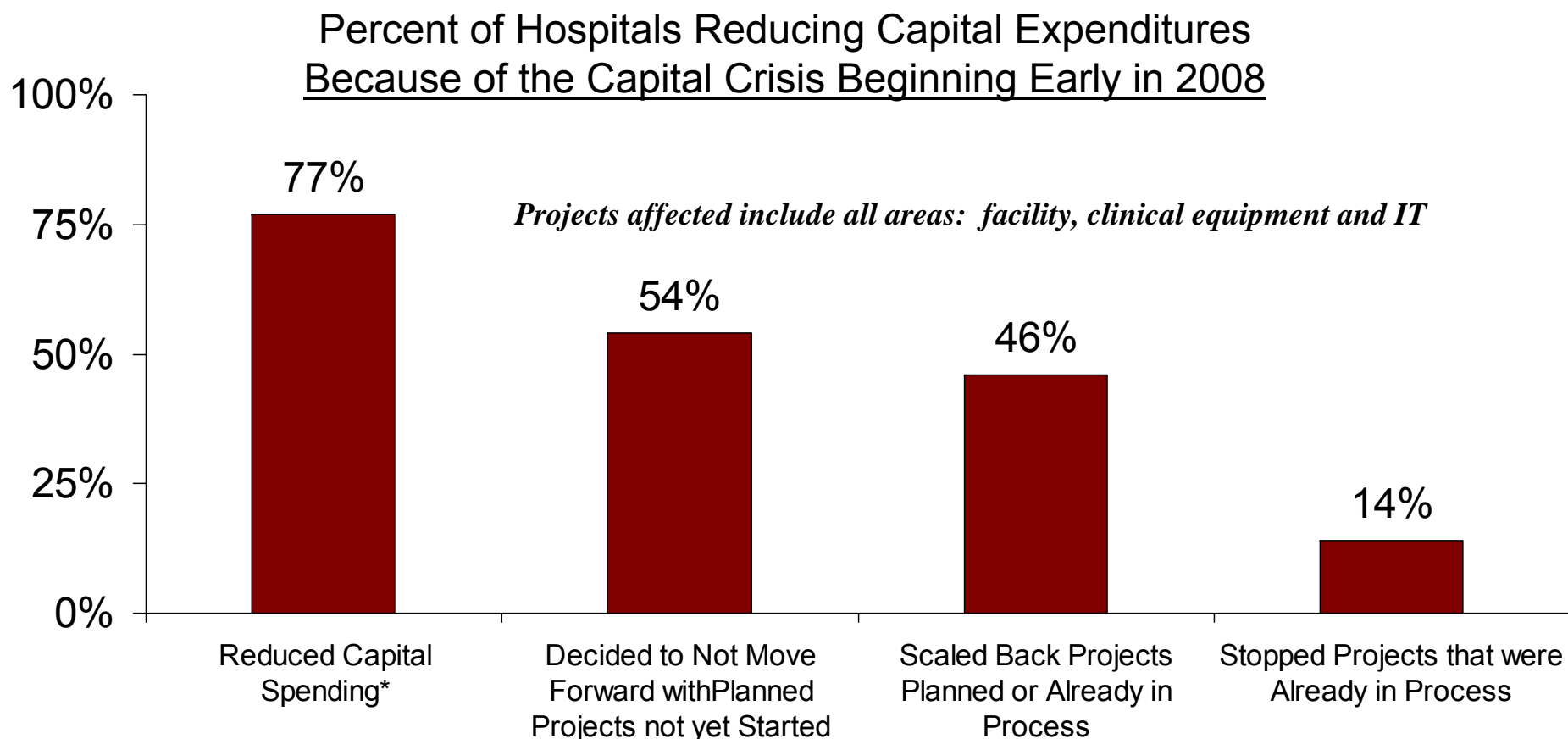


Note: Results based on survey of 1,078 hospital CEOs.

Source: AHA; "The Economic Crisis: The Toll on the Patients and Communities Hospitals Serve," April 27, 2009.

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## Many Hospitals Are Stopping, Postponing, or Scaling Back Projects Planned or Already in Progress

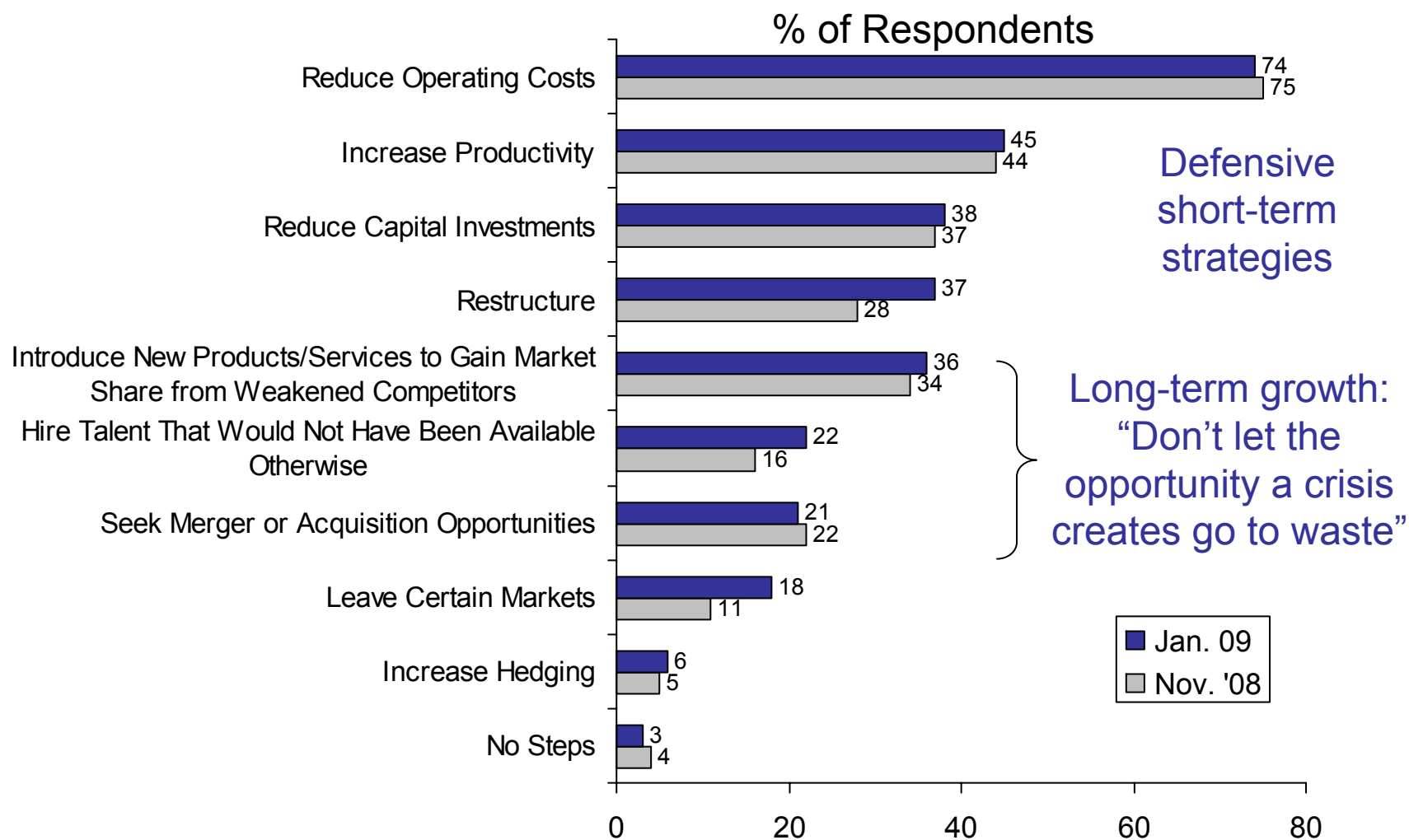


\* Includes any hospital reporting that it had scaled back, decided not to move forward with or stopped projects planned or already in process.

Note: Results based on survey of 1,078 hospital CEOs.

Source: AHA; "The Economic Crisis: The Toll on the Patients and Communities Hospitals Serve," April 27, 2009.

## How Are Other Industries Reacting to the Economic Turmoil?



Note: January 2009 sample size is 1,820; November 2008 sample size is 1,424. The survey was conducted of executives from around the world who represent a full range of industries and functional specialties.

Source: "Economic Conditions Snapshot, February 2009: McKinsey Global Survey Results," *The McKinsey Quarterly*, February 2009.

## Growth and Scale Are Requisite – but Not a Guaranty – for Success in the Future Healthcare Market

Organizations which attain a greater scale generally can better leverage their fixed cost base, deliver higher quality care, achieve variable cost efficiencies, build service area leverage and improve managed care contracting rates, diversify risk across markets or a broader base of programs/ services, optimize long-term access to and cost of capital, and ensure ongoing viability.

However, scale alone does not guaranty success as management's ability to appropriately define and execute on strategic growth plans and deliver on opportunities for scale will define organizational success.

## The Importance of Growth and Scale in Healthcare – What the Capital Markets Are Saying

**“The continues to be a strong correlation between hospital size and bond ratings.** Hospitals with larger revenue and admissions base tend to have higher ratings.

This is due in part to the scope and acuity of services provided, negotiating leverage with commercial health insurers, and the benefit of diversified cash flow typically enjoyed by multi-site systems.”

- Moody’s Investors Service

**“We also believe that many providers have benefited for their size by taking advantage of economies of scale** to improve financial performance.”

- Moody’s Investors Service

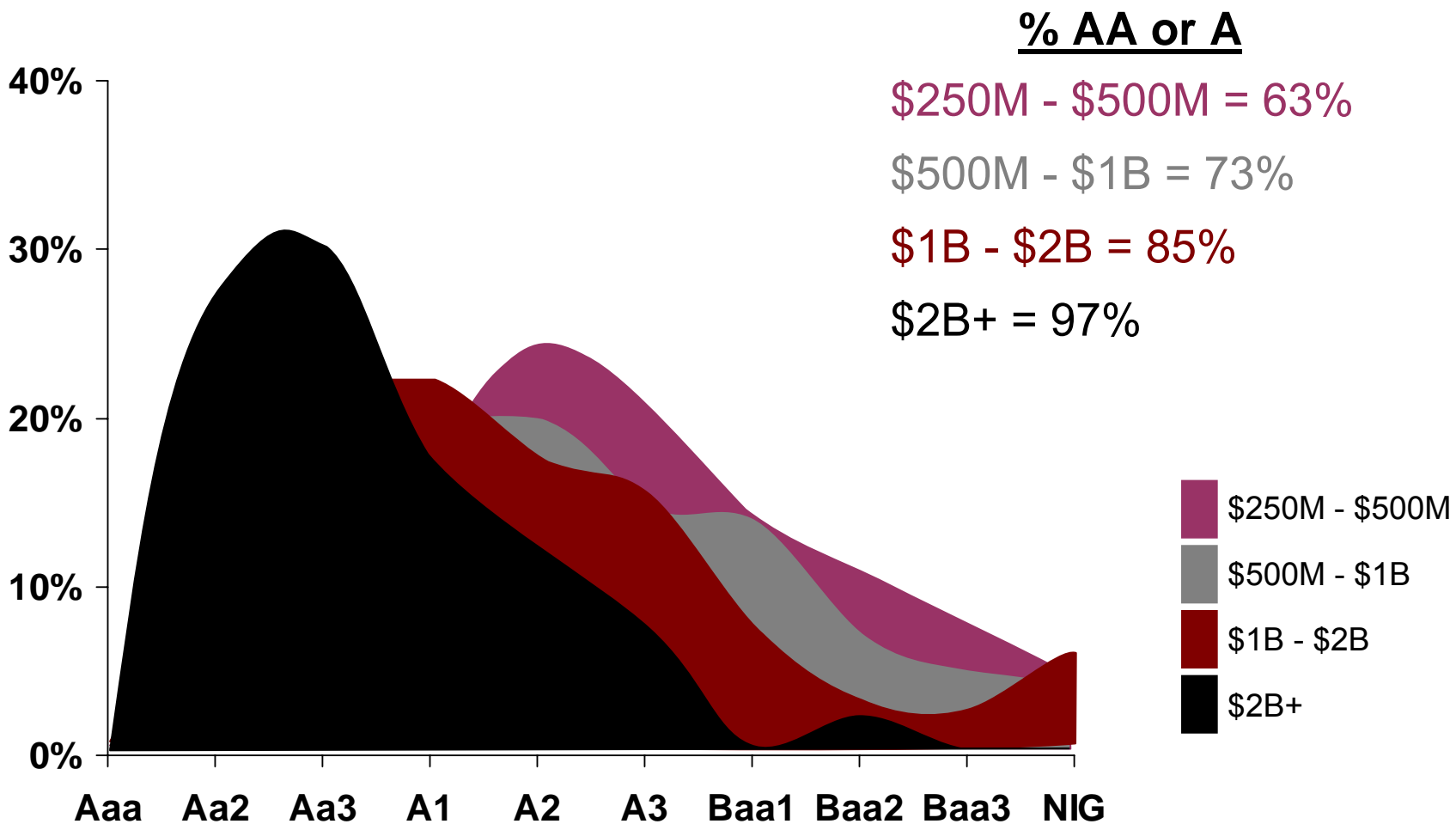
**“We believe smaller and stand-alone hospitals continue to face mounting challenges and are more likely than hospital systems to be downgraded because their size and independence make it harder to stay competitive.”**

**“We believe the ability of providers to invest sufficiently in facilities, equipment, and technology, while maintaining at least an adequate financial profile, will be a key differentiator that will cause the credit quality gap to widen in the next several years.”**

- Standard & Poor’s

Sources: “Moody’s Not-For-Profit Hospital Medians for Fiscal Year 2007,” August 2008 and “Not-for-Profit Healthcare Sector: 2008 Industry Outlook,” January 2008, Moody’s Investors Service; “Tough Times Take a Toll On Credit Quality of U.S. Not-for-Profit Health Care Sector,” Standard & Poor’s, August 25, 2008.

## Moody's Rating Highly Correlated to Scale



## The Market Is Expecting Good Answers to These Questions...

- Strategic Planning** How do you maintain or improve your market position in your service area? How much will it realistically cost? Are you prepared to do what's necessary to compete aggressively? How will competitors react? Then what? How do the physicians fit into your long-term strategy?
- Financial Planning** Can you afford your strategic plan within an acceptable credit and execution risk context? What if you're wrong? Then what? Is it too risky?
- Capital Allocation** How much should you spend? Is spending directed at the right strategies? What is the risk adjusted discounted cash flow return of the capital project portfolio? How has actual versus projected performance measured up?
- Capital Structure** What is the right amount, mix, structure, and cost of debt and equity? How risky is the capital structure?
- Budgeting/ Reporting** Do you have the tools and process to deliver a credible budget tied to your strategic financial plan? Is it achievable? Is there accountability for results? What if you fall short? Then what?
- Exit Rules/ Options** Which services or facilities? Under what conditions? How?

## Healthcare Reform – The Ultimate Market Dynamic

*Proposed Legislation Is Uncertain, but Principles of Reform Have Been Articulated*

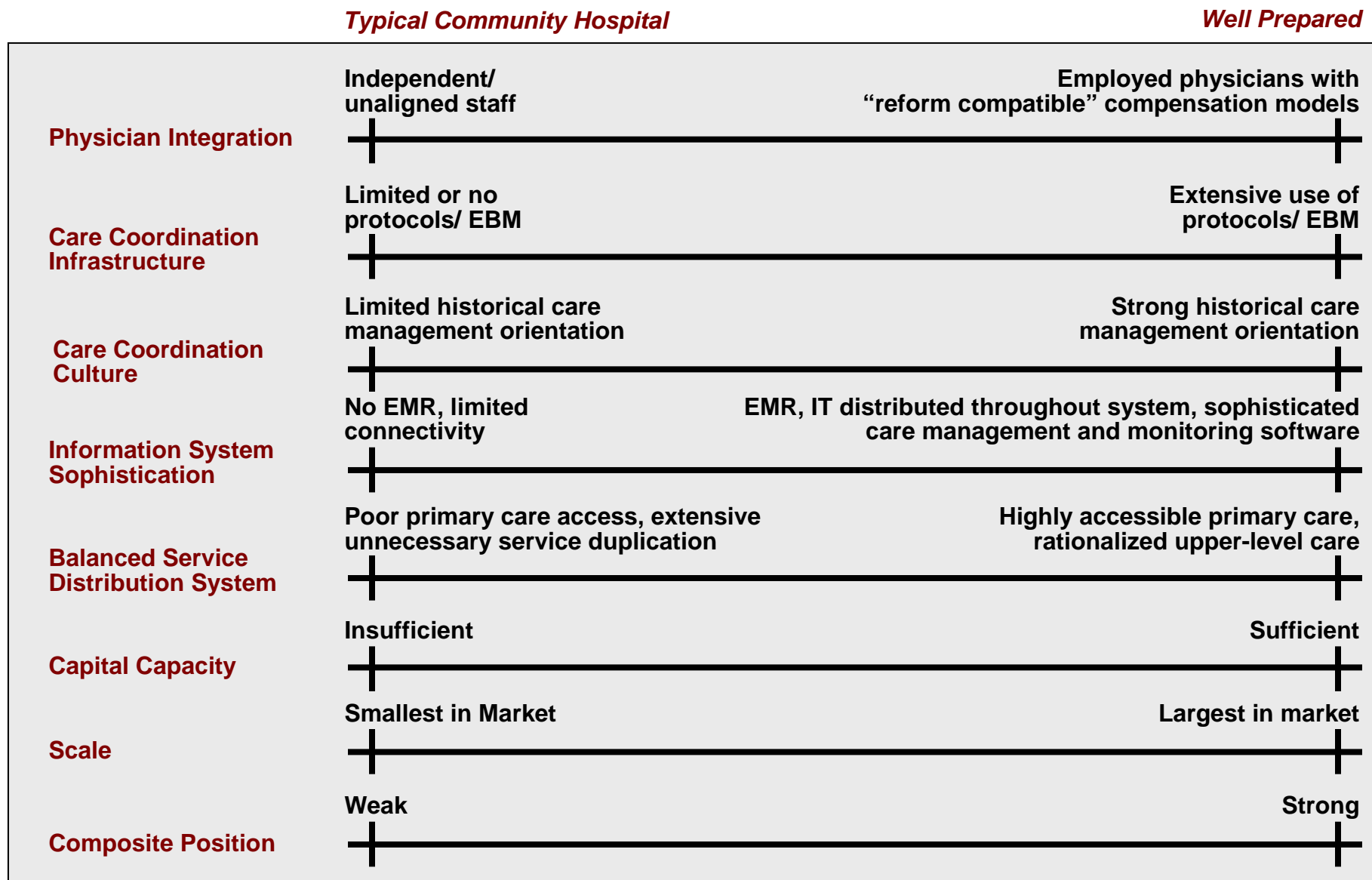
- More stability and security for those who have insurance
- Expansion of the total population that is insured – insurance mandate, business mandate subsidies for the poor, excludes illegal aliens
- Budget neutral – \$830 B to \$1T price tag (over 10 years) covered through reduced costs/ elimination of waste
- Greater provider accountability with a focus on value

## Healthcare Reform

### *Key Potential Mechanisms to Achieve the Stated Cost Savings Goals*

- Payment based on “best practice” levels of value (quality/ cost)
- Bundled payments
- Quality incentive payments
- Reductions in readmission rates
- Reductions in premium increases for Medicare Advantage plans
- Reductions in home health, imaging and other “high margin” service payments
- Medicare drug discounts
- Accountable care organizations

# Required Provider Core Competencies in the New Era



# Final Thoughts

## Thoughts To Consider For 2010

- 1. Long-term access to capital will require focused market strategies and intense operational discipline**
  - Balancing act amongst difficult trade-offs to keep the financial house in order: both income statement and balance sheet
  - Credit position matters more now than ever (access, cost, and flexibility)
- 2. Expect that externalities will play a larger role in all decision making**
  - Bond market disruptions, interest rate volatility, investment losses, pension funding, operating pressures, economic recession, Medicare, etc.
  - Don't count on outside help from the payors, the government, the capital markets, or donors – they all have their own problems to solve
- 3. Protecting the balance sheet in light of emerging market realities continues to translate to capital plan deferrals and/or downsizing for many**
  - Do the projects now provide adequate strategic and financial value?
- 4. Environment will create unprecedented hospital and physician consolidation opportunities**
  - Driven by the search for long-term growth and scale and the need to cut costs and access capital in support of long-term survivability
  - Materially financially impaired organizations may not be able to find a partner

## Thoughts To Consider For 2010 *(continued)*

### **5. Know your bond, bank and swap documents well – issues are surfacing**

- Covenant breaches requiring waivers, consents, swap collateralization, downgrade triggers, springing DSRFs, etc.

### **6. Capital structure risk continues to be front and center**

- Fixed rate bonds are the only form of long-term, committed capital
- Untangling existing capital structures contingent upon insurance ratings, bank LOC availability, swaps, etc. has been more difficult and expensive
- Read the fine print – deal details important to fully understand
- Diversification is ideal, but may not be possible in many circumstances: credit providers, remarketing agents, swap providers, etc.

### **7. If you have to borrow, there's nothing wrong with fixed rate bonds if that market is available to you**

- The low-rate, freewheeling credit environment prior to July 2007 no longer exists – expect interest rates in the 5.5% to 7.5% range, credit depending
- Pay attention to the timing of selling your bonds and what other deals will be in the market at that time – over supply continues to be an issue

## Thoughts To Consider For 2010 (continued)

### **8. Variable rate debt is currently very attractively priced and needs to be considered, but generally requires a stable relationship with a “good bank” and creates exposure to many risks**

- Risks are considerable: interest rate, market dislocation, bond put, bank downgrade, LOC renewal, bank covenants, etc.
- A new ratio to consider: unrestricted cash to variable rate debt

### **9. Non-traditional sources of capital are an option**

- HUD/ FHA 242
- Bank loans (bank qualified and non-bank qualified)
- Real estate monetization
- Leasing

## Sound Capital Management Embraces Three Sources of Risk



- **Business operations risk**
  - Industry
  - Service area
  - Institution-specific operations
- **Investment risk**
  - Institutional decisions
  - Global capital markets
  - Domestic capital markets
- **Financial/ capital risk**
  - Debt structure decisions
  - Absolute borrowing rates
  - Fixed versus floating rates

**These three risks equal an organization's affordable "risk budget" and thus need to be balanced and offsetting. The stronger the credit, the larger the affordable "risk budget", given the implied greater "room for error."**

Questions?

## Ellen G. Riley, *Senior Vice President*

Ellen Riley is a Senior Vice President of Kaufman Hall and has worked out of the Los Angeles office since 1988. She has over 25 years of experience in the healthcare industry. Her experience and responsibilities include developing and providing senior level consulting in all aspects of strategic financial and capital planning, development of capital allocation processes and providing financial advisory services in support of debt transactions and business valuations. Ms. Riley has worked with a diverse group of clients including healthcare systems, academic medical centers, specialty hospitals, community hospitals and children's hospitals.

Ms. Riley is a regular speaker on healthcare finance topics at Healthcare Financial Management Association regional and local chapter educational programs, National Association of Children's Hospitals and Related Institutions, National Council of Health Facilities Finance Authorities and Healthcare Transactions. Additionally, Ms. Riley has been a guest lecturer on healthcare finance topics at the University of California, Los Angeles School of Public Health to graduate students in the Masters of Public Health program. Ms. Riley is currently serving as a member of the USC School of Policy, Planning and Development's Health Advisory Board and is an adjunct professor teaching for the USC School of Policy, Planning and Development's Health Administration program.

Prior to joining Kaufman Hall, Ms. Riley was a Manager in the Los Angeles office of Ernst & Young in the firm's Western Region Healthcare Finance and Business Planning Group. During her six years at Ernst & Young, Ms. Riley directed consulting engagements for healthcare organizations in the areas including financial feasibility assessment, business evaluation and planning, capital planning and formation, acquisition valuation and Certificate of Need preparation.

Before joining the consulting practice at Ernst & Young, Ms. Riley was a Project Analyst in the Corporate Acquisitions and Development Department at National Medical Enterprises, Inc. in Santa Monica, California. In that capacity, she was responsible for financial analyses and due diligence related to hospital acquisition and development projects.

Ellen holds a Masters of Business Administration from the University of Southern California, Graduate School of Business Administration in finance and marketing and a Bachelor of Arts from the University of California at San Diego, graduating with high honors, *Magna Cum Laude*.

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