

Effective Ways to Create Capital Capacity in a Tight Credit Market



January 26, 2010

KaufmanHall

Financial Strategies for Healthcare
5202 Old Orchard Road
Suite N700
Skokie, IL 60077
847.441.8780 phone
847.965.3511 fax
kaufmanhall.com

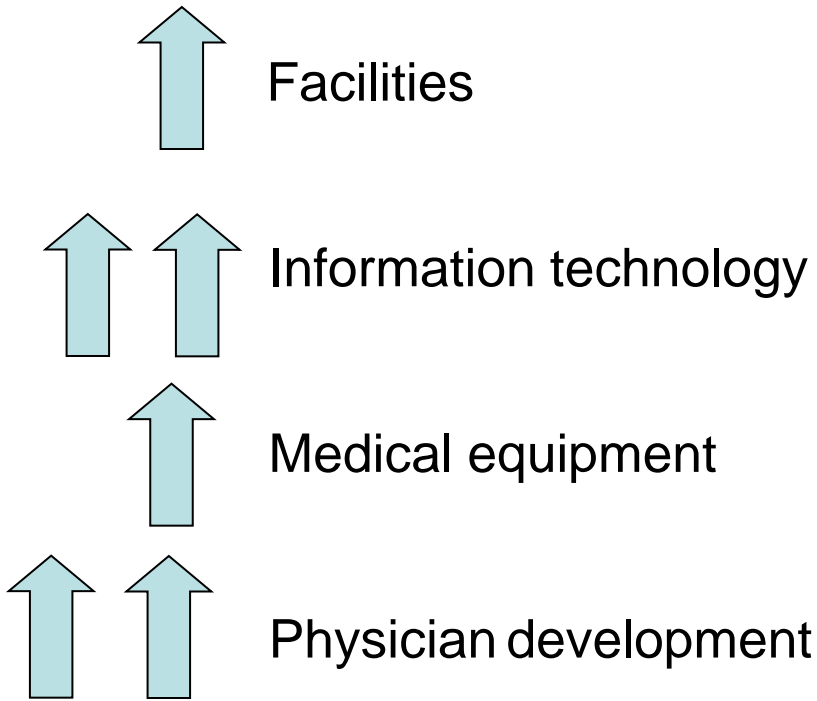
Agenda

- Introduction of Presenters
- The Changing Capital Picture
- Identifying Alternative Capital Sources
- Case Study
- Final Thoughts and Questions and Answers

The Changing Capital Picture

The Changing Capital Picture

Investment Needs
Continue to Escalate



Capital is More Costly
and Sources Declining



The Changing Capital Picture

Implications for Facility Projects

- The need to make smart investments is critical, particularly in facilities where the investment is:
 - Very expensive
 - Long term (30 to 50 years in most cases)
 - Irretrievable (mistakes here just aren't reversible)
- There is a pressing need to explore creative alternatives to major facility investments that are just not affordable in the current (and potentially) longer-term environment
 - The problem that drives need for the investment just doesn't go away because the dollars aren't there

The Changing Capital Picture

Historically, capital spending was growing steadily relative to depreciation expense

| | <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> |
|-------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Capital spending ratio* | 1.3 | 1.4 | 1.5 | 1.5 | 1.6 | ? |

*** Annual additions to property, plant, and equipment
divided by depreciation expense**

However, the construction slowdown in 2008-2009 will likely be reflected in a decreased ratio for FY09 – is this change in the trend for facility investments a “blessing in disguise”?

Health Reform's Two-pronged Impact on Investment Needs

1. The requirement for effective physician alignment and outcome accountability in clinical service delivery

- Bundled payments
- Penalties for high readmission rates
- Penalties for preventable errors
- Penalties for sub-optimal treatment processes

Investment Impact: More \$ required

- Major IT investment in EMR, connections with physician offices, real-time case management information, pharmacy safety systems, etc.
- Major investment in physician alignment – principally through the development of large employed multi-specialty groups and secondarily through alignment strategies with private physicians

2. The cost of increased public subsidy of insurance coverage will create huge pressure on Medicare and Medicaid program budgets

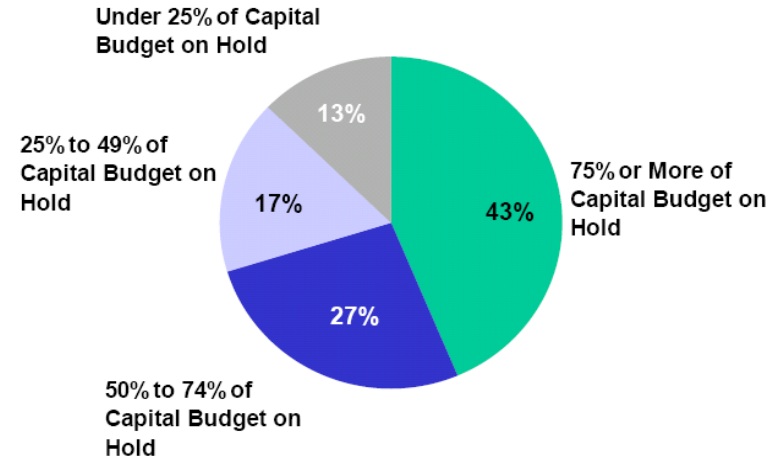
- Reduced payment rates from public sources appears inevitable

Investment Impact: Fewer \$ available

- Lower operating margins will decrease capital capability

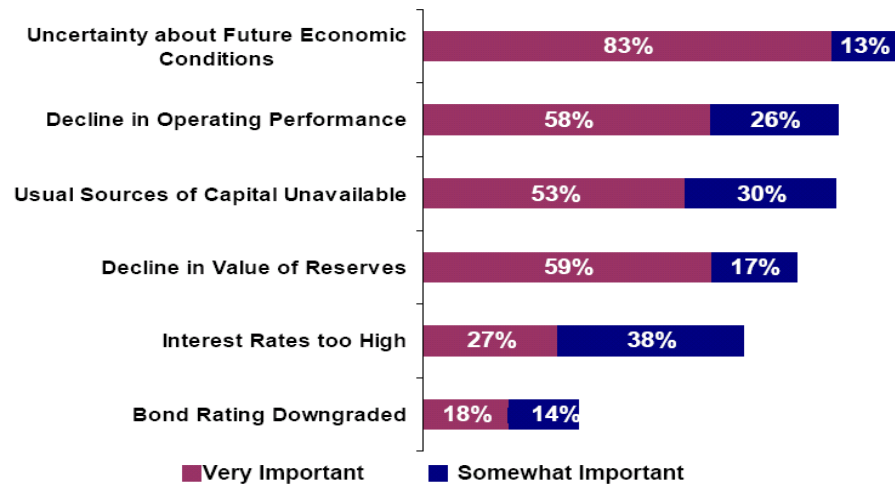
How Much of the Capital Budget is on Hold?

Percent of Hospitals by Portion of Capital Budget Put On Hold
[Includes only those hospitals that indicated they had put capital projects on hold]



Why are Capital Budgets on Hold?

Percent of Hospitals Indicating Key Factors as “Very” or “Somewhat Important” in Decision to Put Projects on Hold
[Includes only hospitals that indicated they had put projects on hold]



Example Hospital Projects On Hold

| | | |
|------------------------------|--------------------|-----------------|
| • Emory, Atlanta | New hospital/other | \$1,500 million |
| • St. Francis, Indianapolis | Major expansion | \$265 million |
| • Pro-Health, Waukesha | New hospital | \$75-90 million |
| • Baylor College of Medicine | New hospital | \$500 million |
| • Banner Health | New hospital | \$128 million |
| • Stonewall Jackson Hospital | New hospital | \$60 million |

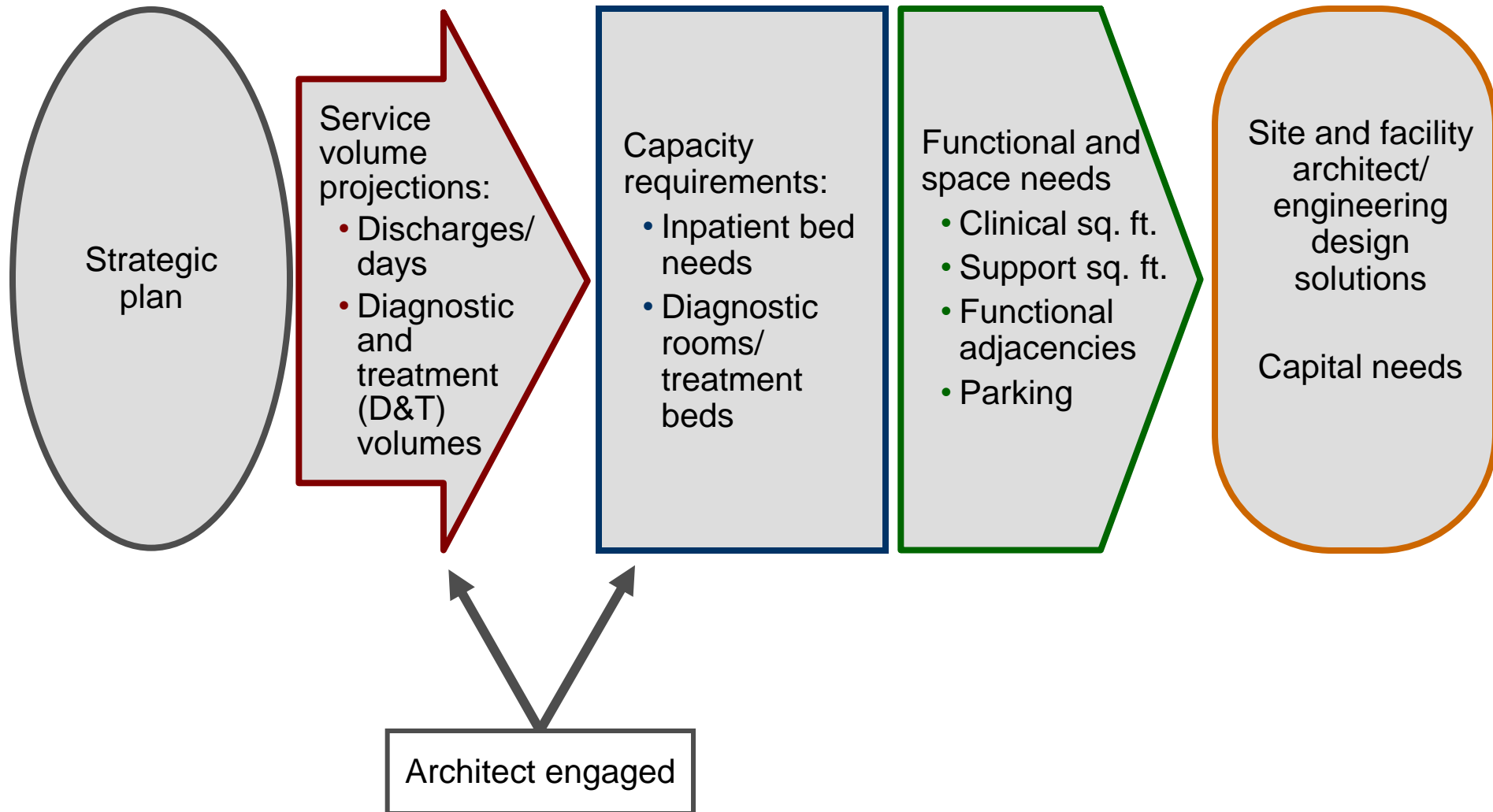
Blessing in Disguise?

The need for major strategic investments in both IT and physician group development means that there will be less available for traditional brick-and-mortar projects

- The credit crisis and recession have forced many organizations to reconsider major facility projects
- We were on a trend of excessive investment in bigger, more expensive facilities that could have consumed most of the capital resources necessary for critical IT and organizational development
- It's time to stand back and carefully assess just how and when we make the brick-and-mortar investments

The industry may well be at a major turning point when it comes to capital investment in facilities

Where and Why Mistakes Are Made in the Typical Facility Planning Process



Why Mistakes Are Made: What's Wrong with the Facility Planning Process? (continued)

- Why/ how does this happen?
 - Management is not knowledgeable of the appropriate benchmarks for facility planning
 - Management assumes that a high-quality, experienced architectural firm or a project management firm will plan and design appropriate space according to good benchmarks
 - The organizational culture of participation and consensus is not controlled
 - management lets the experts (internal clinician experts and the design experts) make key decisions on capacity and square footage with little due diligence oversight
 - Once the budget is approved, a high level of due diligence is often exercised over budget control – but at that point, it's too late... big mistakes are often imbedded in the budget

“What’s the Big Deal About a Few Extra Square Feet?”

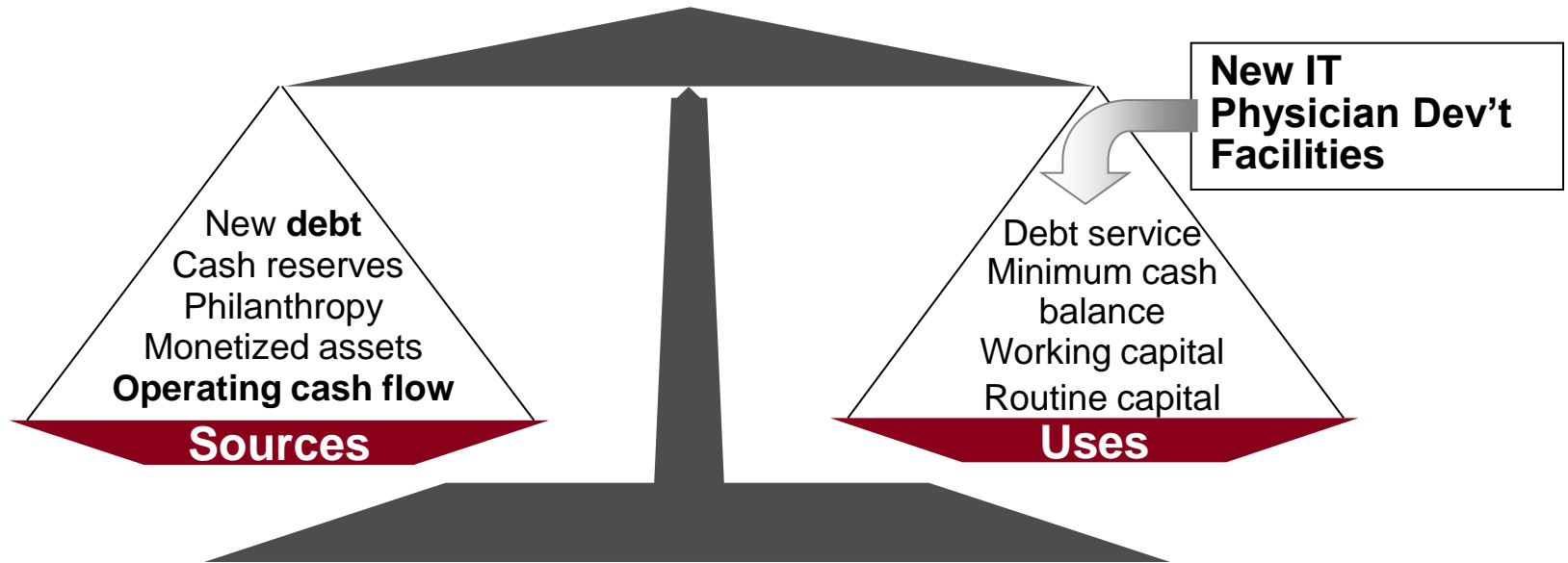
- The opportunity cost: less money for other strategic investment needs
- Ongoing operating cost
 - Utilities
 - Housekeeping
 - General maintenance
 - Staff travel
 - Future upgrades



Perhaps, \$20 to \$30 per square foot per year for 40 years

#1 Know (and Manage) Your Capital Capability

You Must Balance the Sources and Uses of Funds



Debt Capacity = (f) of:

- Operations** profitability (40%)
- Liquidity** position (40%)
- Leverage** position (20%)

Operating cash flow:

- The lynchpin to capital capability: the direct and indirect source of investment funds
- Exploit opportunities for operational efficiencies
 - Optimize top line revenue

Identifying Alternative Capital Sources

Assuring a Viable Organization

The Board and management team are responsible for determining how community needs are best served through the services and activities offered by the healthcare organization. To position the organization for success, leaders must consider the full range of possible options for each of the organization's business units, facilities, and activities, including maintenance, reinvestment, monetization, or termination.

Examples of Business Units Commonly Considered for Monetization

- Managed care plans
- Home health
- Hospice
- Service lines
 - Rehabilitation
 - Behavioral health
 - Dialysis
- Long-term care
 - Skilled nursing
 - Assisted living
 - Independent living
 - Continuing care retirement communities
- Long term acute care hospitals
- Wellness centers
- Pharmacy

Framework for Business Unit Analysis – Key Considerations

Mission/ Community

- How well does the business unit support, execute, fund, or advance the mission of the organization?
- Are the operations supportive of the key objectives of the organization with regard to enhancing patient care (quality, safety, continuum of care, etc.)?
- What level of expectation from the community exists for such services being available by the organization?

Nature of Operations

- To what extent does the business function as a standalone entity (i.e., systems, management, funding of operations, utilization of shared services)?
- Are the operations and activities of the business unit located or performed in space that a patient would view as being within the core operations of the organization?
- What resources (time, effort, capital) are required for the management of the business unit?

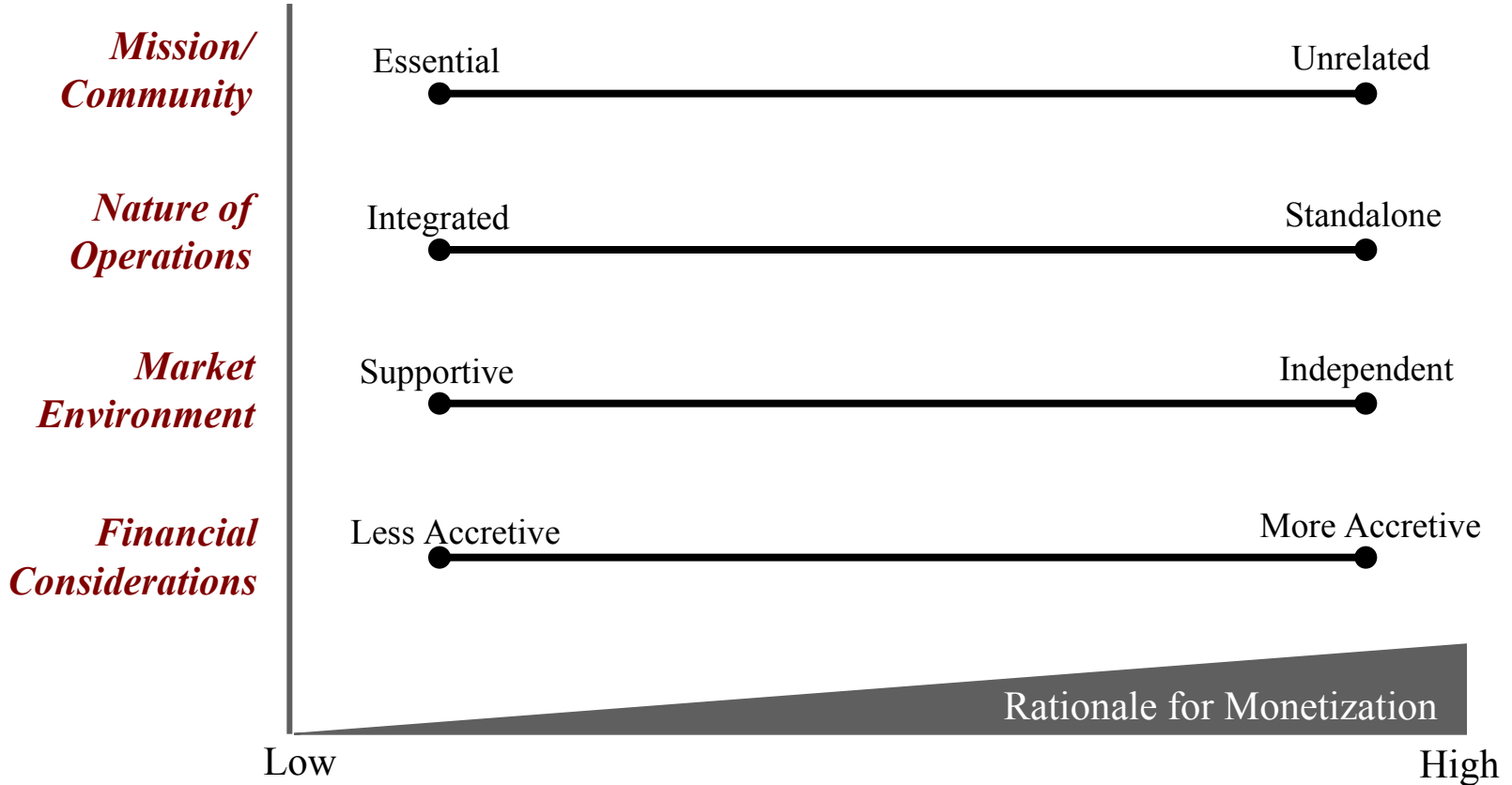
Market Environment

- Does the business unit provide a unique point of differentiation relative to market position, brand, and the activities of competitors?
- Do other external parties (Board, political or community leaders, partners or collaborators) have a particular stake in the business unit's activities or operations?
- Are there key industry factors or trends that impact how successful the business unit would be expected to be in the coming years?

Financial Considerations

- What is the historical financial performance of the business and how is it contributing to the organization's overall financial performance? What are the capital requirements?
- Can the financial performance of the business be segregated in reasonable manner from the organization?
- What is the estimated valuation of the business?
- What impact would various monetization strategies have on the overall credit profile of the organization?

Framework for Analysis of Monetization Potential

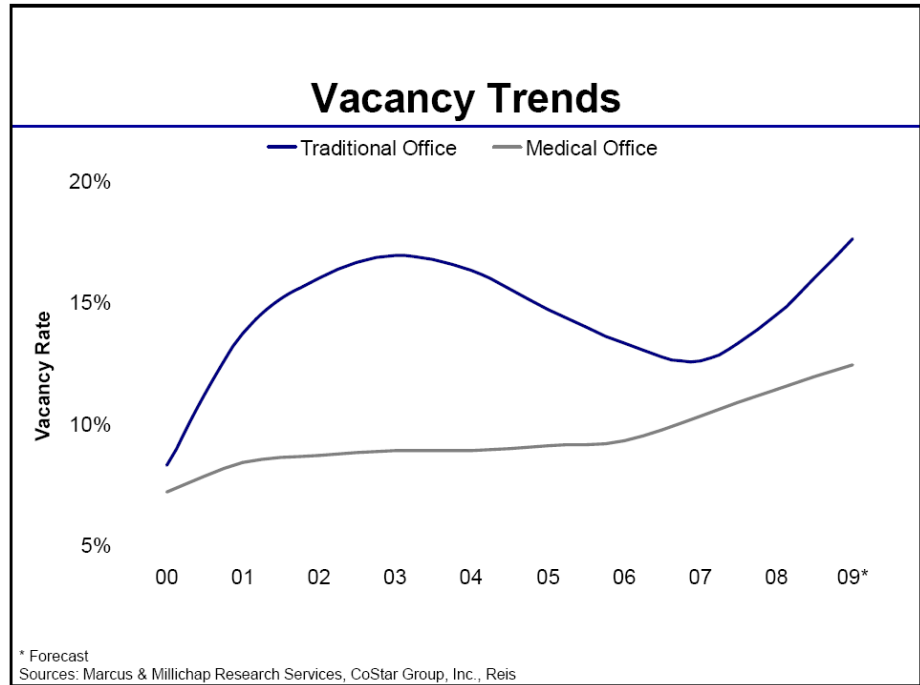
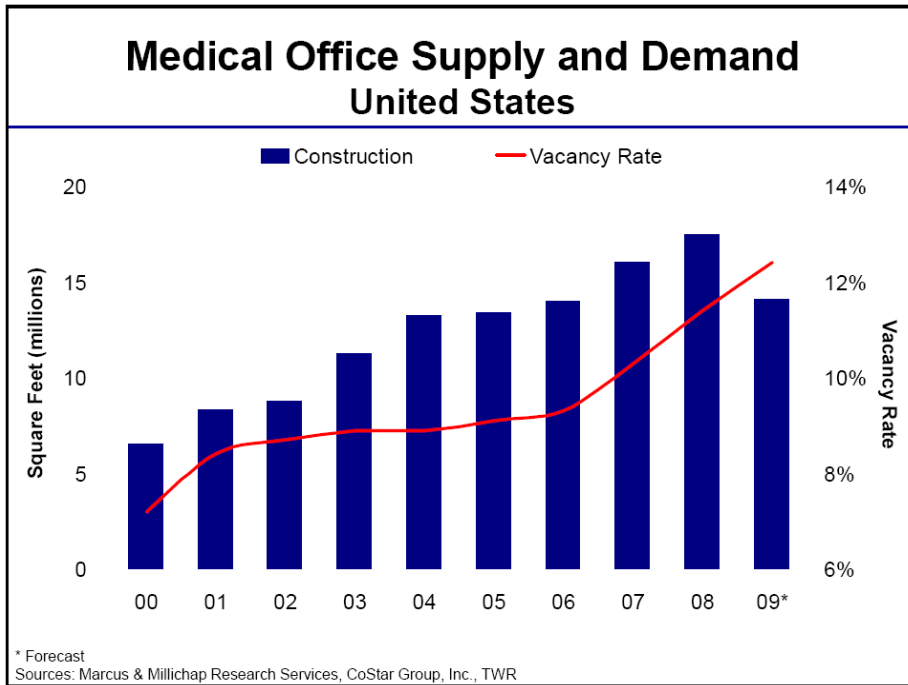


Considerations for Real Estate and Monetization

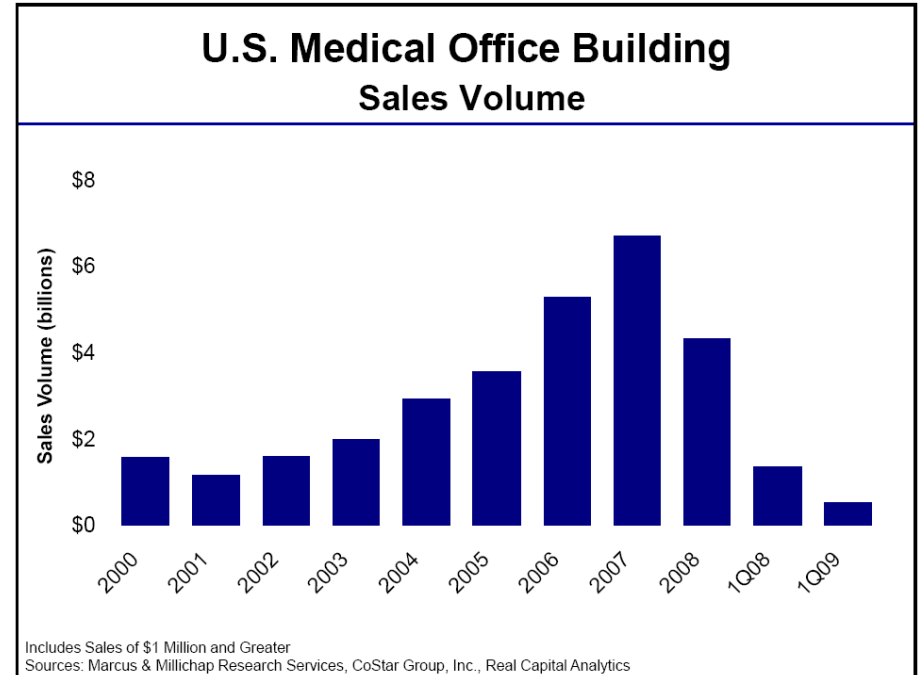
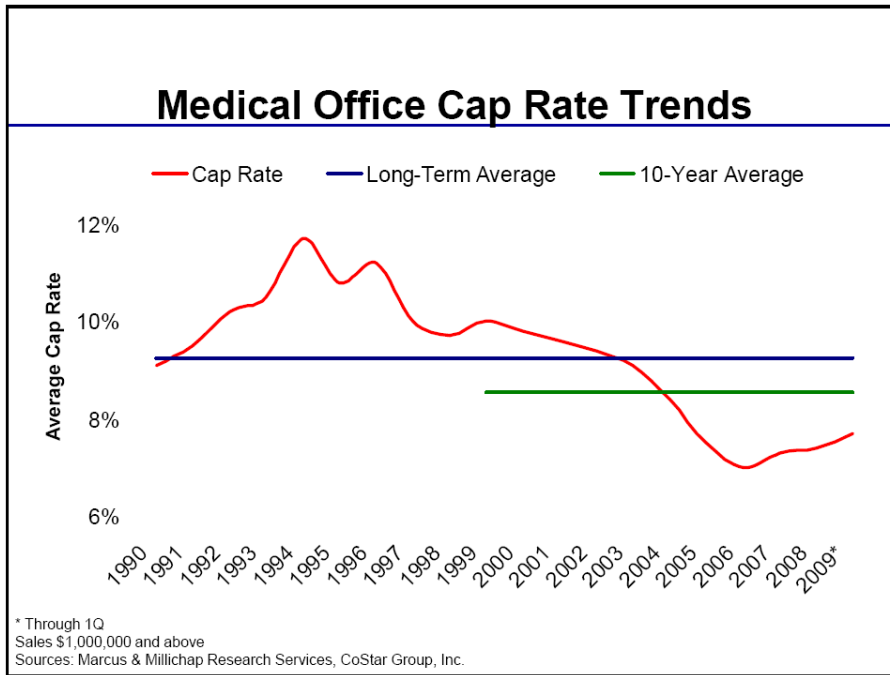
Healthcare Real Estate Market Overview

- Attractive features to investors
 - Healthcare industry's growth drives demand for on- and off-campus real estate:
 - Continued growth in outpatient delivery of healthcare drives real estate development, particularly for medical office buildings
 - Healthcare is 16% of GDP and is expected to reach 20% by 2017
 - First wave of Baby Boomers turned 60 in 2006
 - Americans age 65 and older will total 40 million in 2011 and 60 million in 2021
 - Medical office buildings represent 25% of the \$700 billion healthcare real estate market
 - Medical office buildings offer steady rent and growth, relatively predictable recession-resistant cash flow and high retention rates
 - Medical advances and high capital cost for hospital-centric facilities drive outpatient treatment and services

Vacancy rate trending up but relatively lower than other commercial space



Capitalization Rates (Cap Rates) – Slight uptick, but holding ground



Real Estate

Three key questions every hospital or health system should ask about their real estate at this time:

1. What is the “net” financial advantage or gain in retaining ownership of the real estate we currently hold?
2. If control of key business aspects can be retained, is there a “net” financial advantage or gain in monetizing all or some of the existing (“non-core”) real estate or in using third-party ownership and financing for new development projects?
3. What capital capacity might be created if we monetized real-estate assets and obtained third-party capital for our new development projects?

Rating Agency Considerations

- Independent of accounting classification for hospital leased space, rating agencies will undertake their own “on credit/ off credit” review, depending on the circumstances
- Generally speaking, the rating agencies review real estate activities within the framework of the following questions:
 - What is the overall business strategy with the real estate?
 - ✓ From a business perspective, what activities are taking place on- and off-campus?
 - ✓ How does the real estate relate to any physician strategy?
 - What is the real use of the space?
 - ✓ Although a hospital or system might have converted owned space to leased space, will the services provided in the space ever move and are such services core to the organization’s business strategy and mission?
- Moody’s Investors Service may calculate present value of certain “operating lease” obligations
 - Factors include respective lease amounts, term, and discount rate
 - Generally speaking, if the present value of operating lease obligations is within 10% of total long-term debt, such obligations will not adversely effect credit
- Standard & Poor’s and Fitch Ratings incorporate more of a debt service coverage approach, rather than “debt equivalent”

Own vs. Lease – Effect on Income Statement

| Year of Transaction | Ongoing |
|--|--|
| <p>Other revenue</p> <ul style="list-style-type: none"> • Gain: ground lease income • Loss: rental income from 3rd party tenants | <p>Other revenue</p> <ul style="list-style-type: none"> • Gain: ground lease income • Loss: rental income from 3rd party tenants • Return on invested capital |
| <p>Operating expenses</p> <ul style="list-style-type: none"> • Decreased depreciation expenses • Increased occupancy expense for rents • Decreased interest expense for real estate debt | <p>Operating expenses</p> <ul style="list-style-type: none"> • Decreased depreciation expenses • Increased occupancy expense for rents • Decreased interest expense for real estate debt |
| <p>Non-operating income</p> <ul style="list-style-type: none"> • Gain from asset sale • Earnings on invested funds | <p>Non-operating income</p> <ul style="list-style-type: none"> • Earnings on invested funds |

Optimizing the capital structure for new development projects

- The metrics related to “own vs. lease” analysis to monetize real estate are very similar to decision to own or lease for proposed development project
- Two frameworks for analysis should include impact on overall long-range financial planning on project specific discounted cash flow
- Key drivers include factors such as:
 - Relative occupancy
 - Construction/ development cost
 - Assumed financing structure
 - Capital appreciation and inflation assumptions
 - Lease-up/ re-new and re-lease assumptions
 - Operating & capital expenses
 - Real estate taxes

Ground Lease – Maintaining Strategic Control

For strategic properties, buildings can be sold subject to a ground lease with control provisions. Examples include:

- Right of first refusal/ option to lease
- Design approval and exterior modifications
- Naming and signage rights
- Approval of marketing material
- Security
- Telecommunications – roof access
- Additions to improvements
- Property management
- Use restrictions
- Restrictions of future ownership

Case Study: Comprehensive Business Unit and Real Estate Monetization

Health System Overview

- Health System is comprised of two hospitals (main campus and satellite hospital) along with a number of ancillary businesses, including:
 - Long-term care (assisted and independent living)
 - Behavioral health
 - Employee assistance program
 - Health and fitness center
 - Receivables management business
 - Retail pharmacy
- Service area is suburban and consists of two counties with a total population of approximately 385,000. The population is expected to grow 2-3% over the next five years. Demographics are generally favorable.
- Highly competitive market with major system competitors and other community hospitals; competitors are making significant strategic investments (inpatient, outpatient and physician) in the Health System's market
- A+ rating with negative outlook from S&P and A1 with stable outlook from Moody's

Credit Profile

| Ratio/Statistic (\$ millions) | Moody's A1 | Year Ended September 30 | | |
|-------------------------------------|---------------|-------------------------|---------|---------|
| | | FY06 | FY07 | FY08 |
| Net Patient Service Revenue | \$401.4 | \$490.6 | \$519.1 | \$648.7 |
| Operating Income | \$10.7 | \$23.6 | \$34.0 | \$34.3 |
| Net Income | \$23.9 | \$37.6 | \$62.0 | (\$4.1) |
| Unrestricted Cash | \$201.1 | \$295.0 | \$364.3 | \$293.0 |
| Total Debt ⁽¹⁾ | \$156.3 | \$271.4 | \$271.0 | \$316.6 |
| Capital Expenditures | \$29.8 | \$36.5 | \$45.9 | \$77.8 |
| Profitability | | | | |
| Operating Margin | 2.6% | 4.5% | 6.1% | 4.9% |
| Excess Margin | 5.6% | 6.9% | 10.5% | (0.6%) |
| Operating EBIDA Margin | 9.6% | 14.7% | 15.7% | 13.5% |
| Debt Position ⁽²⁾ | | | | |
| Annual Debt Service Coverage (x) | 4.8x | 4.6x | 6.0x | 2.5x |
| Debt to Capitalization | 34.4% | 39.4% | 37.4% | 42.8% |
| Liquidity | | | | |
| Cash to Debt | 141.8% | 108.7% | 134.4% | 92.5% |
| Days Cash On Hand (days) | 189.9 | 231.0 | 273.5 | 173.5 |
| Other | | | | |
| Days in A/R, net | 51.3 | 44.5 | 40.5 | 45.6 |
| Average Age of Plant | 9.5 | 9.1 | 9.5 | 10.3 |
| Capital Spending Ratio | 150.0% | 90.2% | 112.9% | 180.1% |
| Compensation Ratio | ----- | 56.7% | 55.0% | 57.9% |

Note:

(1) Total debt calculation includes revolving credit, current installment of LT debt, capital leases and LT debt

(2) Annual debt service includes prior years current maturity of LT debt plus current year's interest payment

- The health system, like all providers, has experienced substantial erosion in its balance sheet since September 30
- The health system has a number of strategic projects which are critical to the organization's future success; these projects total over \$400 million

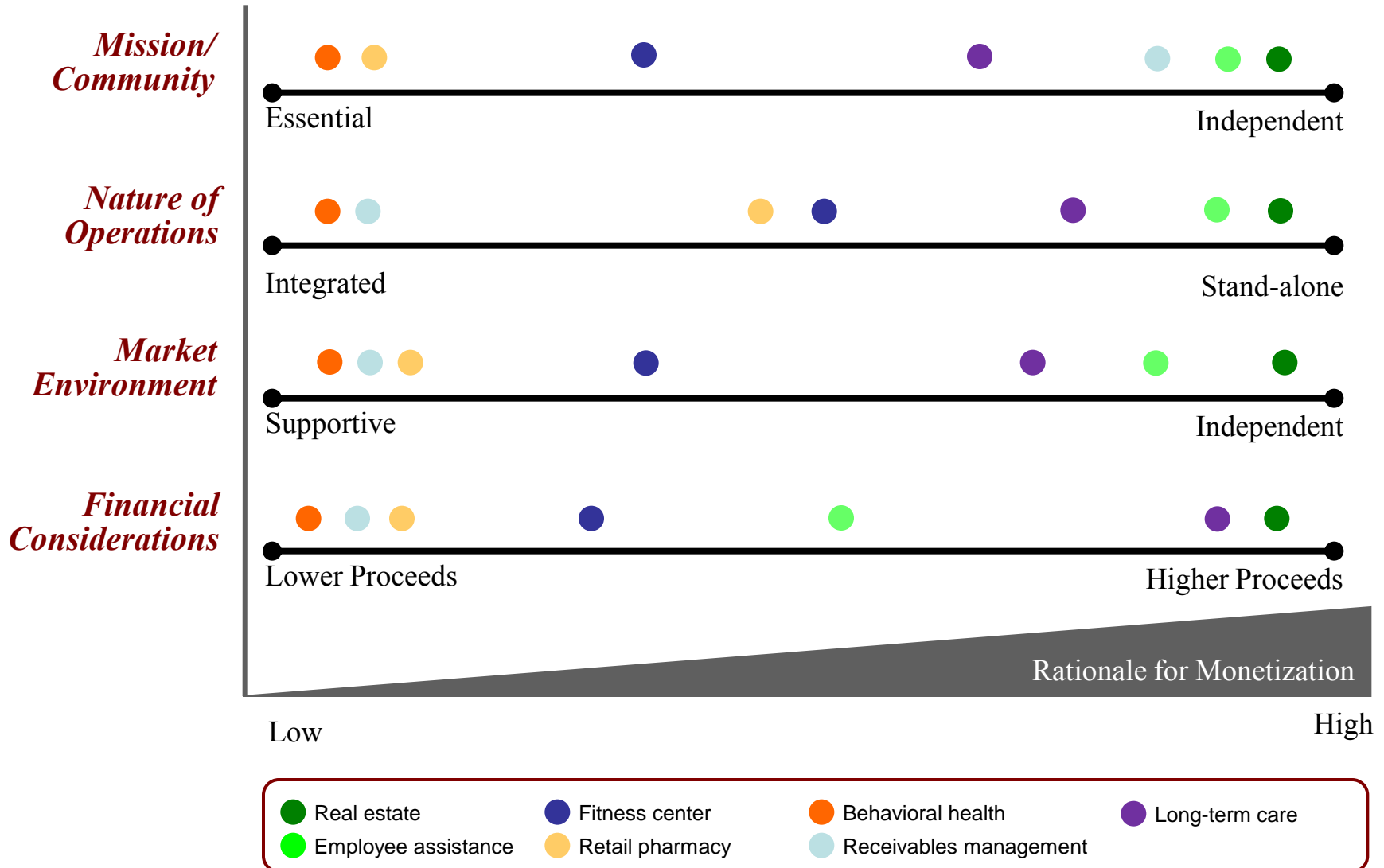
Evaluation Criteria

- In the initial meetings with the health system, a number of transaction goals were articulated, which included:
 - Enhancing the financial performance of the core operations of the System
 - Creating capital capacity for System requirements and initiatives
 - Using the System’s staff and other resources appropriately
 - Remaining mindful of opportunities to increase physician alignment
 - Where appropriate, maximizing the potential proceeds from monetization
- Balanced against these goals was the strict adherence to the activities and functions of those business units that exemplify the mission of the organization
 - As appropriate, other qualitative considerations were also considered as part of the review

Prioritizing the Review of Business Units

- A comprehensive list of businesses and assets were identified and prioritized based upon discussions with management
- The following were deemed high priority and were evaluated in the analysis:
 - Real estate (11 buildings, 400,000 sq. ft.)
 - Employee assistance program
 - Health and fitness center
 - Receivables management business
 - Retail pharmacy
 - Behavioral health
 - Long-term care business
- Other businesses were discussed and reviewed and deemed not high priority for this analysis and thus, were not evaluated

Conclusions of Monetization Analysis – Comparative Assessment



Net Proceeds Analysis

- The following summary of a net proceeds analysis illustrates the potential cash proceeds to the health system in the monetization of select businesses and assets

| | Enterprise Value | | Debt | Cash | Transaction Expenses | | Estimated Net Proceeds | |
|------------------------------------|----------------------|----------------------|---------------------|---------------------|----------------------|--------------------|------------------------|---------------------|
| | Low | High | | | Low | High | Low | High |
| Real Estate | \$59,442,064 | \$68,761,574 | \$24,560,053 | \$0 | \$1,188,841 | \$1,375,231 | \$33,693,169 | \$42,826,289 |
| Employee Assistance Program | \$9,000,000 | \$11,000,000 | \$10,000 | \$12,237,000 | \$750,000 | \$1,500,000 | \$20,477,000 | \$21,727,000 |
| Long Term Care Business | \$54,000,000 | \$64,000,000 | \$33,545,000 | \$3,864,000 | \$1,000,000 | \$1,500,000 | \$23,319,000 | \$32,819,000 |
| Total | <u>\$122,442,064</u> | <u>\$143,761,574</u> | <u>\$58,115,053</u> | <u>\$16,101,000</u> | <u>\$2,938,841</u> | <u>\$4,375,231</u> | <u>\$77,489,169</u> | <u>\$97,372,289</u> |

Impact on Financial Position

| Ratio/Statistic (\$ millions) | Moody's A1 | Year Ended September 30 | | | Including Gain on Sale of Discontinued Assets | Excluding Gain on Sale of Discontinued Assets |
|-------------------------------------|---------------|-------------------------|---------|---------|---|---|
| | | FY06 | FY07 | FY08 | ProForma FY08 ⁽³⁾ | ProForma FY08 |
| Net Patient Service Revenue | \$401.4 | \$490.6 | \$519.1 | \$648.7 | \$648.7 | \$648.7 |
| Operating Income | \$10.7 | \$23.6 | \$34.0 | \$34.3 | \$29.8 | \$29.8 |
| Net Income | \$23.9 | \$37.6 | \$62.0 | (\$4.1) | \$79.7 | (\$3.6) |
| Unrestricted Cash | \$201.1 | \$295.0 | \$364.3 | \$293.0 | \$369.8 | \$369.8 |
| Total Debt ⁽¹⁾ | \$156.3 | \$271.4 | \$271.0 | \$316.6 | \$257.2 | \$257.2 |
| Capital Expenditures | \$29.8 | \$36.5 | \$45.9 | \$77.8 | \$77.8 | \$77.8 |
| Profitability | | | | | | |
| Operating Margin | 2.6% | 4.5% | 6.1% | 4.9% | 4.5% | 4.5% |
| Excess Margin | 5.6% | 6.9% | 10.5% | (0.6%) | 11.2% | (0.6%) |
| Operating EBIDA Margin | 9.6% | 14.7% | 15.7% | 13.5% | 12.3% | 12.3% |
| Debt Position ⁽²⁾ | | | | | | |
| Annual Debt Service Coverage (x) | 4.8x | 4.6x | 6.0x | 2.5x | 7.0x | 2.5x |
| Debt to Capitalization | 34.4% | 39.4% | 37.4% | 42.8% | 35.3% | 35.3% |
| Liquidity | | | | | | |
| Cash to Debt | 141.8% | 108.7% | 134.4% | 92.5% | 143.8% | 143.8% |
| Days Cash On Hand (days) | 189.9 | 231.0 | 273.5 | 173.5 | 227.1 | 227.1 |
| Other | | | | | | |
| Days in A/R, net | 51.3 | 44.5 | 40.5 | 45.6 | 45.1 | 45.1 |
| Average Age of Plant | 9.5 | 9.1 | 9.5 | 10.3 | 11.4 | 11.4 |
| Capital Spending Ratio | 150.0% | 90.2% | 112.9% | 180.1% | 200.5% | 200.5% |
| Compensation Ratio | ----- | 56.7% | 55.0% | 57.9% | 56.2% | 56.2% |

Note:

- (1) Total debt calculation includes revolving credit, current installment of LT debt, capital leases and LT debt
- (2) Annual debt service includes prior years current maturity of LT debt plus current year's interest payment
- (3) Gain on sale does not include tax implications, if any, of sale of real estate owned by a for-profit subsidiary

- The monetization of these assets are estimated to create approximately \$120-\$140 million of additional capital capacity to the health system

Recommendations

- Consider the divestiture of long term care business and employee assistance program
- Consider the monetization of certain real estate assets
- Evaluate performance improvement measures for behavioral health
 - Outside management providers
 - Other revenue enhancement/ cost containment potential
 - Rationalization
- Consider third-party management contracts or ventures, if appropriate, for retail pharmacy
- Consider the potential divestiture or management contract for fitness center
- Retain receivables management business for the short term and continue to monitor its capital needs

Final Thoughts and Questions and Answers

Conclusions

- In light of continued industry-wide operating and capital pressures and periodic public debt market dislocations, nearly every hospital provider is considering alternate and non-traditional forms of capital generation
- Goals, objectives and strategies vary, but generally underperforming non-core services and real estate with relatively low hospital owner occupancy are attractive candidates for consideration
- For those providers with limited debt capacity, business unit and real estate strategies may be an important near-term source of capital funds to supplement operating cash flow
- Careful deliberation and due diligence is required, especially in analyzing and understanding the current and future accounting and credit implications of real estate monetization and developer financed alternatives

Speaker Bios

Jim Medendorp, *Vice President*

Jim Medendorp is a Vice President of Kaufman Hall and a member of the firm's strategy practice. With extensive consulting experience in healthcare facility planning, his responsibilities focus on facility master planning, functional and space programming, strategic planning, operational redesign, and hard asset management.

During the past 10 years, Mr. Medendorp has programmed and planned more than 15 replacement or new hospital facilities, and developed master facility plans resulting in more than 4 billion dollars of construction. Mr. Medendorp has also provided many clients with second opinion consultancy to review proposed facility projects and identify opportunities to reduce costs, improve patient and staff flows, and get stalled projects back on track. His architecture background, coupled with his facility planning expertise, provides clients with solutions that maximize the use of capital resources and enhance revenue generation.

Prior to joining Kaufman Hall, Mr. Medendorp worked at Wellspring Valuation/Huron Consulting Group as a director leading the facility planning and hard asset valuation practice.

Mr. Medendorp holds an M.A. in Architecture and a B.S. in Architecture from the University of Michigan, Ann Arbor.

Jim Medendorp

Vice President

Kaufman, Hall & Associates, Inc.

5202 Old Orchard Road, Suite N700

Skokie, Illinois 60077

voice#: (847) 441-8780 x125, e-mail: jmedendorp@kaufmanhall.com

www.kaufmanhall.com

Joseph Euphrat, *Vice President*

Joe Euphrat is a Vice President for Kaufman Hall, responsible for the firm's real estate advisory group in the mergers and acquisitions practice. With extensive experience in capital finance and healthcare real estate, Mr. Euphrat works with both small and large healthcare systems, providing financial and capital formation strategy advisory services.

Mr. Euphrat's expertise in tax-exempt debt finance enables him to develop real estate solutions that are part of the overall capital strategy of healthcare providers. His work includes identification of core and non-core assets, monetization of real estate holdings, development of key control provisions included in ground leases, and competitive outsourcing of institutional capital for new development projects.

Prior to joining Kaufman Hall, Mr. Euphrat was with Shattuck Hammond Partners, where he provided real estate solutions to healthcare providers. Before this, he worked with Lehman Brothers and Prudential Securities, where he headed the U.S. western region healthcare practice.

Mr. Euphrat has a B.S. from Haas School of Business at the University of California, Berkeley.

Joseph Euphrat
Vice President
Kaufman, Hall & Associates, Inc.
5202 Old Orchard Road, Suite N700
Skokie, Illinois 60077
voice#: (847) 441-8780 x159, e-mail: jeuphrat@kaufmanhall.com
www.kaufmanhall.com