

Capital Markets Update and Implications for Borrowers in 2010



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HFMA Region 9

Agenda

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

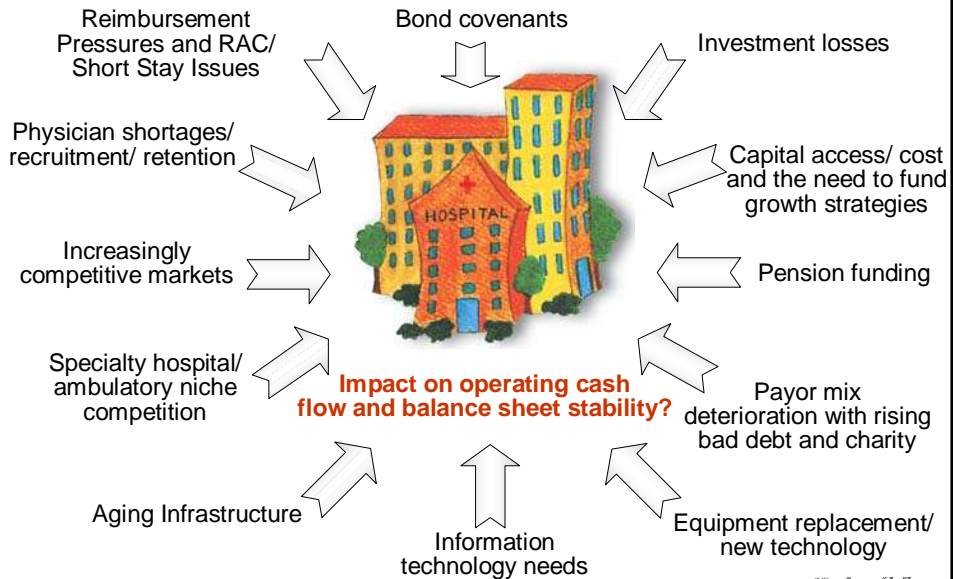
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Current Market Environment and Industry Trends

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

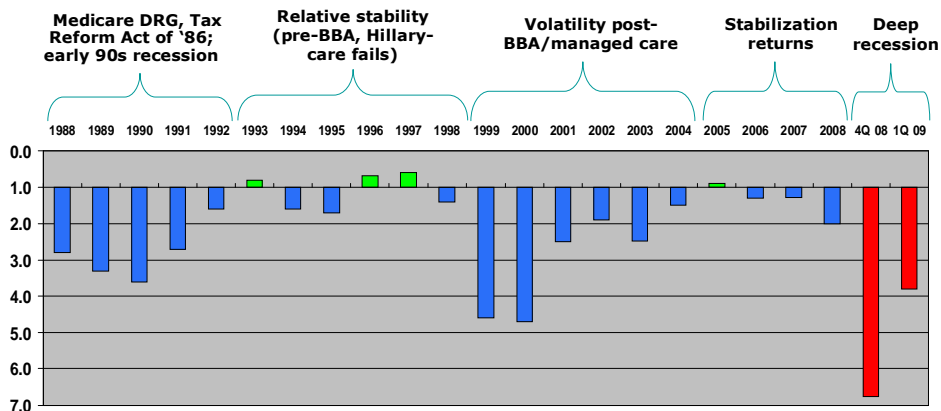
1. Physician alignment strategies: employment, joint ventures, etc.
2. Aging facilities, obsolete care configurations and capacity constraints
3. IT requirements and increasingly costly technology
4. Growth, scale and market consolidation initiatives

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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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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.

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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

Source: Adapted from Moody's "Not-for-Profit Healthcare Sector Outlook Revised to Negative from Stable", November 2008.

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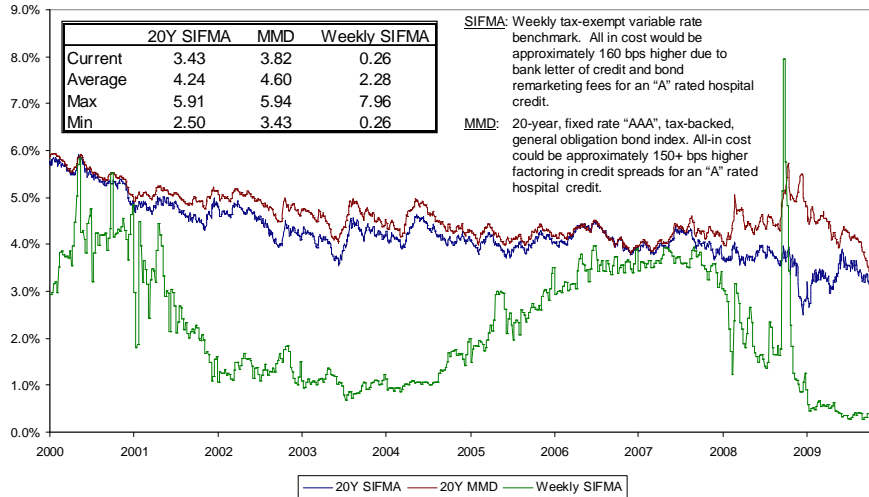
Rating Agency Perspective Implications

- **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**

Capital Markets Update

Tax-exempt Market Benchmark Indices

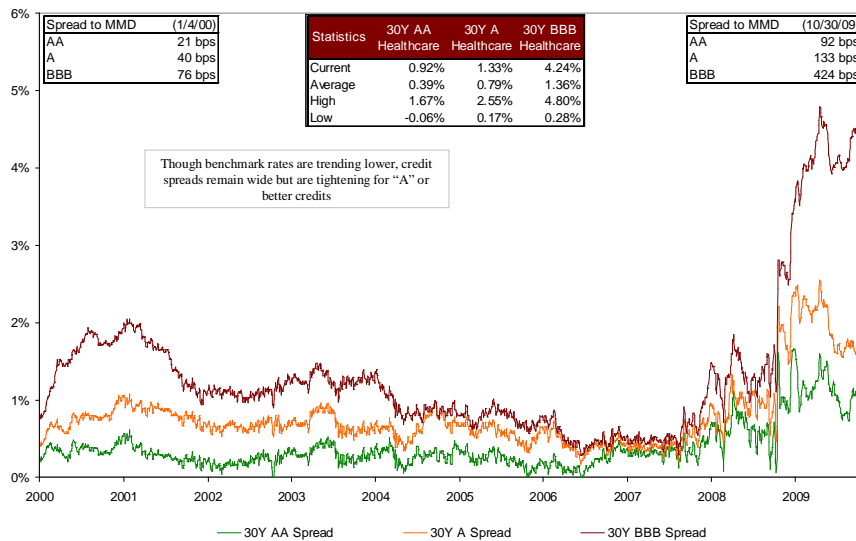
Trend of Tax-Exempt Rates



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Healthcare Credit Spreads Are Well Above Average

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



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Capital Markets Have 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 in

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
Interest rate increase	<ul style="list-style-type: none"> Fixed payor swaps, if in place, may act as a hedge against general rate inflation via short-term LIBOR assuming a correlation is maintained Portfolio returns on any short-term/ fixed-income investments 	<ul style="list-style-type: none"> Stay the course Refinance to fixed (more expensive) Cash prepayment
Tax rates decline	<ul style="list-style-type: none"> None, but seems very unlikely in the near term 	<ul style="list-style-type: none"> Stay the course Refinance to fixed (more expensive) Cash prepayment
Healthcare industry risks	<ul style="list-style-type: none"> 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) 	<ul style="list-style-type: none"> Stay the course Refinance to fixed (more expensive) Cash prepayment
Borrower credit downgrade	<ul style="list-style-type: none"> Bank LOC usually okay if Borrower is at least mid "A" category or higher (will affect pricing and availability, though) 	<ul style="list-style-type: none"> Stay the course Refinance to fixed (more expensive) Cash prepayment
Bank downgrade	<ul style="list-style-type: none"> Use highly rated banks Ability to replace LOC provider if alternates exist 	<ul style="list-style-type: none"> Stay the course Refinance to fixed (more expensive) Cash prepayment Replace LOC provider
Bank LOC renewal	<ul style="list-style-type: none"> Maintenance of Borrower's credit rating in the "A" category or better Use relationship bank Ability to replace LOC provider Add "evergreen" provisions or longer-dated renewal terms (3 years, if available) 	<ul style="list-style-type: none"> Stay the course Refinance to fixed (more expensive) Cash prepayment Replace LOC provider
VRDN market demand/ supply concerns and dislocation	<ul style="list-style-type: none"> Historical stability/ marketability of VRDN market up until now 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% 	<ul style="list-style-type: none"> Stay the course Refinance to fixed (more expensive) Cash prepayment
Failed debt remarketing (bank put)	<ul style="list-style-type: none"> Bank term out provides time to fix (depending on the course of the put – bank, market, remarketing agent, etc.) 	<ul style="list-style-type: none"> Stay the course Refinance to fixed (more expensive) Cash prepayment Replace LOC provider
Inability of bank to fund a bond put	<ul style="list-style-type: none"> Check documents for provisions and procedures as to whether this is an event of default 	<ul style="list-style-type: none"> Refinance to fixed (more expensive) Cash prepayment Replace LOC provider

Additionally, rating agencies have expressed considerable "event risk" concern

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How Are Top Performing Providers Responding to the Current Environment?

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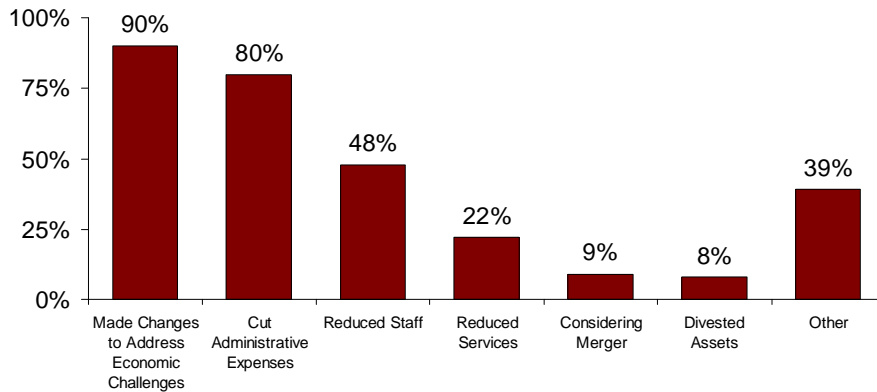
Back to Business Basics

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

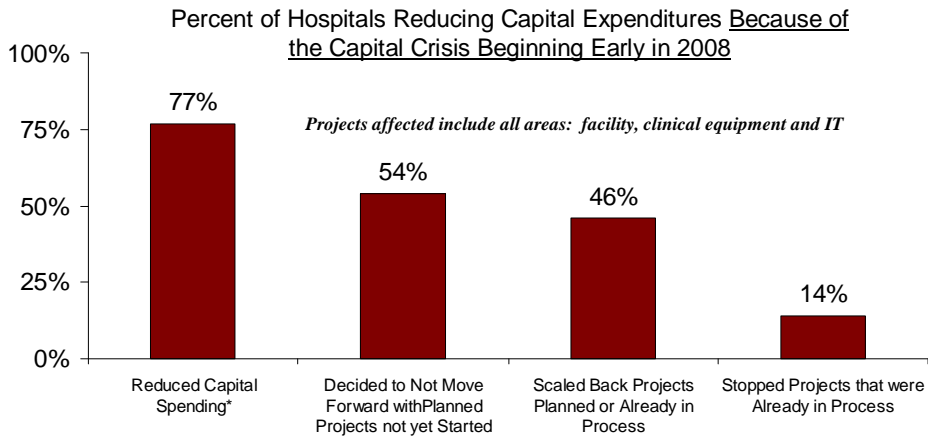
Nearly All Hospitals Are Making Changes to Address Current and Expected Economic Challenges

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.

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

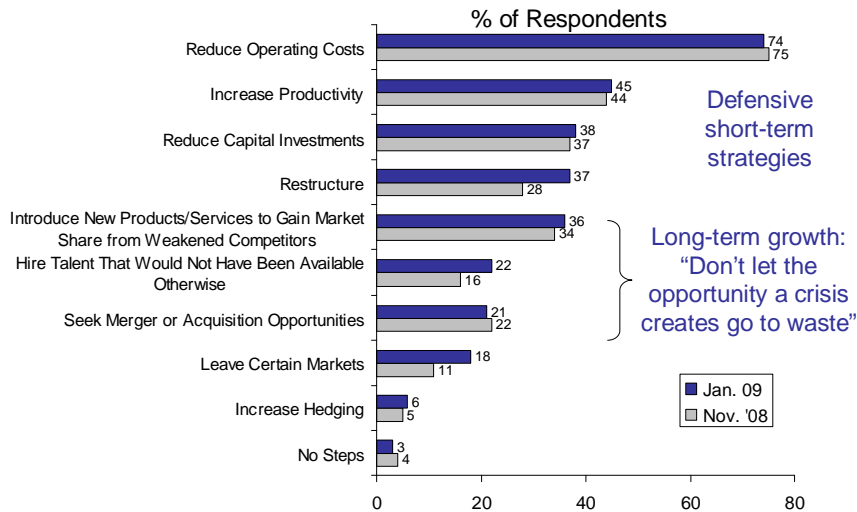


* Includes any hospital reporting that it had scaled back, decided not to move forward with or stopped projects planned or already in process.
 Note: Results based on survey of 1,078 hospital CEOs.
 Source: AHA; "The Economic Crisis: The Toll on the Patients and Communities Hospitals Serve," April 27, 2009.

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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.

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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."

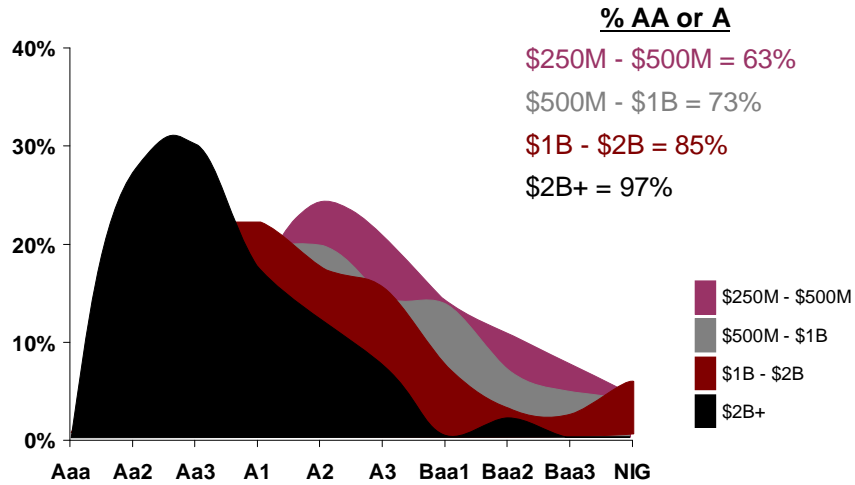
- Moody's Investors Service

"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

Moody's Rating Highly Correlated to Scale



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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?

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Final Thoughts

Thoughts Heading Into 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 Heading Into 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 Heading Into 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

Questions?

Speaker Bio

Andrew J. Majka Partner and Chief Operating Officer

Mr. Majka is a Partner and Chief Operating Officer with Kaufman, Hall & Associates and has been with the firm since June 1993. In his tenure with the firm, Mr. Majka has been very active in financial and capital planning, debt-related financial advisory and merger/acquisition/divestiture engagements for a wide range of healthcare clients, including many multi-state healthcare systems, academic medical centers, stand-alone community providers and large physician group practices. In particular, Mr. Majka has collaborated with numerous providers in the development and execution of best practices financial and capital planning within the context of strengthening the mission, preserving credit rating and optimizing access to capital. Since 1993, Mr. Majka has been a financial advisor to over \$18 billion in tax-exempt health care financings and over \$10 billion in derivatives.

Mr. Majka is a frequent speaker on health care finance topics, and was presented twice with a Distinguished Speaker Award by the Health Care Financial Management Association in connection with the Annual National Institute. Additionally, Mr. Majka has been a recent speaker at various national and regional educational programs for the HFMA, VHA and other health care professional organizations including the Governance Institute and the ACHE.

Mr. Majka has a Masters Degree in Business Administration from the University of Wisconsin-Madison with a concentration in Finance. He received a Bachelor of Science degree with honors from the University of California-Davis.

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