Agenda

• Industry Perspective and Credit Implications
• 2009 Capital Markets Re-Cap: The Good, the Bad and the Ugly
• Capital Markets Update In the New Economy
• Thoughts Heading into 2010
• Questions
Industry Perspective
and Credit Implications
Feeling Squeezed Even Before the Impact of Healthcare Reform?

- Reimbursement pressures and RAC/short stay issues
- Investment losses
- Physician shortages/recruitment/retention
- Capital access/cost and the need to fund growth strategies
- Increasingly competitive markets
- Pension funding
- Specialty hospital/ambulatory niche competition
- Payor mix deterioration with rising bad debt and charity
- Aging Infrastructure
- Equipment replacement/new technology
- Information technology needs
- Impact on operating cash flow and balance sheet stability?
Deteriorating Industry Metrics Beginning in 2008

Pre-healthcare reform the industry has already experienced:

- Strained operating performance (volume decline, reimbursement, bad debt/charity, etc.)
- Considerable pressure on liquidity (investments, pension, etc.)
- Capital needs to address aging facilities, IT, physician integration and strategic investment outweighing available resources
- Negative industry outlook by all three rating agencies
- More downgrades expected

Note: Based on overall median information published by Fitch Ratings, Moody’s Investors Service and Standard & Poor’s. Some differences in ratio definitions and in credits are included.
The industry has experienced more downgrades than upgrades in 17 out of the last 21 years.
Rating Agency Perspective Implications

• Negative rating agency outlook and 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 liquidity, capital structure and investment portfolio risk
  – Cash: Not all investments are liquid
  – 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
Financial Creditworthiness and Access to Capital Matters Now More than Ever

• Virtually no healthcare system is able to fund its long-term capital requirements from operating cash flow and/or cash reserves
  – Access to outside capital, over the long-term, is an imperative

• Creditworthy organizations have better/ more flexible capital access
  – Less restrictive terms, conditions and provisions
  – Access to public and private markets (fixed and variable options)
  – Access to credit enhancement
  – Taxable or tax-exempt debt

• Creditworthy organizations have a lower cost of capital
  – Credit spreads are extraordinarily high: “AA” to “A” = 75+ bps
  – Access to low cost variable-rate debt
  – Lower issuance costs: insurance premium, letter/ line of credit, underwriting/ remarketing

• Creditworthy organizations are market consolidators
  – Organizations with the highest credit rating have been the most attractive partners, have excess capital capacity and the lowest cost of capital to consolidate and remain successful in their respective markets
2009 Capital Markets Re-Cap: The Good, the Bad, and the Ugly
“If you’re going through hell, keep going”

Winston Churchill
2009: The Good

- **Fixed-Rate Debt Market Access**
  - Market reopened in Q1 to “AA” and then “A” credits after a virtual four-month closure with limited access emerging for stronger “BBB” credits by Q2
  - Taxable Build America Bond popularity amongst general municipal issuers removed considerable potential competing tax-exempt paper from the market
  - Rate and access normalization by Q3
  - Heavy healthcare issuer supply in Q4 eroded earlier gains – especially by highly rated credits – but market remained relatively resilient

- **Variable Rates Remained Extraordinarily Low due to Fed Policy**
  - 2009 SIFMA (floating rate index): median (0.38%), max (0.67%), min (0.22%), standard deviation (0.13%)
  - Limited number of failed remarketings/ rate spikes as evidenced in late 2008

- **Investment Portfolio Partial Recovery**
  - 65% increase in S&P 500 from March 2009 low, but 28% off July 2007 high

- **Rising long-term LIBOR rates improved mark-to-market valuation of deeply out of the money fixed payor swap positions**
  - Reduction in very significant collateral postings
2009: The Bad

• **Fixed-Rate Debt Market Rate Volatility**
  – Early (Q1) and late (Q4) issuers experienced very wide credit spreads due to supply and demand imbalances and market uncertainty

• **Buyers Market Resulted in Stronger Security and Covenants**
  – **Security**: revenue pledge, mortgages, funded debt service reserve fund
  – **More onerous maintenance covenants**: days cash, coverage, and in some cases debt to cap
  – **More restrictive incurrence tests**: asset transfer (especially cash transfers outside obligated group), debt incurrence, permitted liens, etc.

• **Bank Letter of Credit Market Erosion**
  – Mergers, downgrades, and capital restrictions resulted in a reduction of available banks with adequate ratings and an ability to commit capital
  – Higher costs, more covenants, more tie-ins to other business, etc.
  – Some initial signs of improvement in Q4, though

• **Continued Virtual Destruction of Municipal Bond Insurance**
  – Essentially one non-federal player (Assured/ FSA) – can add value in fixed rate debt situations for lower credits, but not a full credit transfer (buyers will look through to the underlying credit)
2009: The Ugly

- **Negative Industry Outlooks by All Three Rating Agencies**

- **2008/2009 Crisis Left Many Organizations With Short-term Fixes and Sub-Optimal Capital Structures**
  - Over weighted fixed rate exposure: Due to out of the money fixed payor swaps left in place, inability to access bank LOC market or complete risk avoidance
  - Over weighted uncommitted variable rate exposure: Loss of bond insurance, loss of auction market, and fixed rate access/costs left many organizations with too much bank-backed LOC debt
  - Duration mismatch of uncommitted, short-term, LOC-backed debt frequently matched against long-term fixed payor swap hedges
  - Cash flow/collateral impact of “orphan” swaps left in place after underlying variable-rate debt was refinanced to fixed

- **Bond/Bank Document Covenant Defaults and Tripped “Springers”**
  - Many contributing factors: realized portfolio losses, swap collateral, operating losses, higher-than-expected interest rates in 2008, etc.
  - Tripped springing provisions: mortgage and debt service reserve fund funding

- **Bracing for Uncertain Impact of Healthcare Reform**
Capital Markets Update in the New Economy
Our “Old Economy” Capital Market Assumptions Are No Longer Valid

1. Cheap/dependable capital access would be facilitated
   - A fully functioning marketplace
   - Investment banks as a backstop

2. Credit enhancement availability to improve market access and lower cost
   - Expanded buyer universe even for mediocre and unsophisticated credits
   - Access to alternative products and structures with ostensibly lower cost and full commitment

3. Cash retention/creation would generate net investment returns
   - Cash as protection during volatile times
   - Dependence on net positive returns to bolster operating “bumps in the road” and support higher credit ratings

4. Ready availability of funding for large strategic and facility plans
   - Assumed access to investor dollars
   - Only uncertainty related to cost, covenants, and security
Capital Market Assumptions: The New Economy

• Access to capital is no longer a “given” for every credit and every project – the market is sorting out winners/losers
• Fixed-rate bonds are the sole form of fully committed capital
• Fixed rate credit spreads remain wide, and cost of capital has increased for all organizations
• LOC-backed variable-rate debt is largely uncommitted capital with considerable and unpredictable event risk
• Pull back in credit enhancement (bond insurance and bank letters of credit) requires borrower’s to protect and rely more on their underlying credit rating/fundamentals
• When push comes to shove, you can’t expect the investment or commercial banks to provide a reliable backstop to your capital structure under all circumstances
Unsettling Near-term Potential Wild Cards in the New Economy

1. Pronounced inflation expectation
2. Saturation of long-term Treasury bond issuance pushing up rates
3. Increasing supply of tax-exempt debt, especially when (if) the taxable Build America Bond program ends, pushing general muni issuers back into tax-exempt market competing with hospitals
4. Healthcare industry sector saturation as more borrowers issue fixed-rate debt and buyers get “full up” on healthcare allocation
5. Further bank industry collapse (e.g., commercial real estate, credit card debt, etc.)
6. Severe capital markets dislocation/ further liquidity crises
7. Healthcare industry reform
8. Large-scale hospital bankruptcy announcement (e.g., AHERF in the 90s)
9. Over supply of new fixed-rate issues
10. More confidence in equities, real estate, or commodities shifting money out of tax-exempt bonds
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 need to be balanced and offsetting
✓ The stronger the credit, the larger the affordable “risk budget” given the implied greater “room for error”
✓ Hospitals must determine the degree of their business and investment risk, which will drive funding decisions
Your Primary Capital Sources Today: Good, but Not Great, and No One Size Fits All

1. Variable-rate demand bonds supported by a commercial bank letter of credit or self liquidity
2. Fixed-rate bonds
3. Private placements (generally fixed)
4. Direct bank lending (bank or non-bank qualified)
5. Capital/ operating leasing
6. Asset monetization/ developer-funded structures
7. Operations
8. Working capital management (A/R reduction and A/P extension)
9. Outside support: grants, philanthropy, payor rate increases, government tax support, etc.
10. Capital investment deferral, downsizing, and/or elimination
11. Outside capital partner (merger, joint venture, etc.)
12. Other
Long-Term, Fixed-Rate Investors Remain Cautious

- 30-year fixed rate access, costs and terms highly dependent on credit rating, perceived staying power and state tax advantages to investors
  - “AA”: 5.5%+
  - “A”: 5.8%+
  - “BBB”: 6.3%+

- 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
  - Buying opportunity for retail investors
Long-Term, Fixed-Rate Investors Remain Cautious

- Continue to 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 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 quality, timeliness and responsiveness**
    - 45 to 60 days quarterly (yes, all 4 quarters) and 120 to 150 days audit
    - Direct obligation to investors
20-year MMD Fixed Rate, Tax-exempt, G.O. Issuer Benchmark Trend Has Been Favorable

Current Rate: 3.70%
% Observations Below Current Rate: 0.66%
Historical Average: 5.51%
Historical Max: 8.85%
Historical Min: 3.43%
Healthcare Bond Credit Spreads Have Widened

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

<table>
<thead>
<tr>
<th></th>
<th>Spread to MMD (1/4/00)</th>
<th>Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>30Y AA Healthcare</td>
</tr>
<tr>
<td>AA</td>
<td>21 bps</td>
<td>Current: 1.02%</td>
</tr>
<tr>
<td>A</td>
<td>40 bps</td>
<td>Average: 0.40%</td>
</tr>
<tr>
<td>BBB</td>
<td>76 bps</td>
<td>High: 1.67%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Low: -0.06%</td>
</tr>
</tbody>
</table>

Spread to MMD (12/31/09)

<table>
<thead>
<tr>
<th></th>
<th>AA</th>
<th>102 bps</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>154 bps</td>
<td></td>
</tr>
<tr>
<td>BBB</td>
<td>434 bps</td>
<td></td>
</tr>
</tbody>
</table>

Copyright 2010 Kaufman, Hall & Associates, Inc. All rights reserved.
Short-Term, Variable Rate Investors Looking for Safety and Liquidity Continue to Step Up… for Now

- Large money market funds remain the backbone of this market
- VRDBs supported by “good banks” remain attractive
  - “Good banks” have the highest ratings (perceived staying power) and are not overexposed in the LOC market
  - Monitor long-term and short-term ratings carefully – many banks have either been downgraded, have negative outlooks, or are on credit watch
- 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?
- How long will investors accept short-term, tax-exempt rates yielding under 0.3% vs. moving into other higher-yielding investment opportunities (equities, real estate, commodities, etc.)?
How Long Will the Fed Continue to Keep Short-term Rates Low?

- **Near-Zero Short-Term Rate**
  - Target Fed Funds Rate

- **Resulting Short-Term Market Rates**
  - SIFMA vs. 67% 1-Month LIBOR

Graphs showing the timeline from 2003 to 2010.
Access to Bank Letters of Credit Remains Okay for Now, but 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 complicated/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 remarketing failure: 3-5 yrs

• Restrictive and highly negotiated covenants, security, and termination provisions
  – Be mindful of 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, etc.)

• Significant tie-in with other commercial banking services a given
Can/Will Commercial Banks Support an Expected Peak in 2011 LOC Renewals?

LOC Expirations/Renewals
2004 to 2015

($ Millions)

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.

Copyright 2010 Kaufman, Hall & Associates, Inc. All rights reserved.
## A Reminder of Primary Variable Rate Demand Note Risks

<table>
<thead>
<tr>
<th>Risk</th>
<th>Mitigating factors</th>
<th>Options</th>
</tr>
</thead>
</table>
| Interest rate increase              | - 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 | - Stay the course  
- Refinance to fixed (more expensive)  
- Cash prepayment                     |
| Tax rates decline                   | - None, but seems very unlikely in the near term                                    | - Stay the course  
- Refinance to fixed (more expensive)  
- Cash prepayment                     |
| Healthcare industry risks           | - 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) | - Stay the course  
- Refinance to fixed (more expensive)  
- Cash prepayment                     |
| Borrower credit downgrade          | - Bank LOC usually okay if Borrower is at least mid “A” category or higher (will affect pricing and availability, though) | - Stay the course  
- Refinance to fixed (more expensive)  
- Cash prepayment                     |
| Bank downgrade                      | - Use highly rated banks  
- Ability to replace LOC provider if alternates exist                                | - Stay the course  
- Refinance to fixed (more expensive)  
- Cash prepayment  
- Replace LOC provider                 |
| Bank LOC renewal                    | - 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) | - Stay the course  
- Refinance to fixed (more expensive)  
- Cash prepayment  
- Replace LOC provider                 |
| VRDN market demand/ supply concerns and dislocation | - 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% | - Stay the course  
- Refinance to fixed (more expensive)  
- Cash prepayment                     |
| Failed debt remarketing (bank put) | - Bank term out provides time to fix (depending on the course of the put – bank, market, remarketing agent, etc.) | - Stay the course  
- Refinance to fixed (more expensive)  
- Cash prepayment  
- Replace LOC provider                 |
| Inability of bank to fund a bond put | - Check documents for provisions and procedures as to whether this is an event of default | - Refinance to fixed (more expensive)  
- Cash prepayment  
- Replace LOC provider                 |
Where Do We Go from Here?
The Credit Markets Continue to Expect Market Winners to Have 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?
The Emerging Success Model Will Require…

1. Scale and size
2. A strong position and multiple operations in the geographies served
3. A solid, integrated physician platform
4. A care, cost, and quality management culture
5. Sophisticated IT and care management infrastructures
6. Acute attention to operations and business portfolio management with consistent and appropriate levels of operating cash flow performance
7. A durable balance sheet with an appropriate capital structure
8. Access to capital and the ability to fund capital needs internally from time to time during market volatility
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
   - 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
   – unpleasant issues are continuing to surface
     – 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. Nontraditional sources of capital are an option
   - HUD/ FHA 242
   - Bank loans (bank qualified and non-bank qualified)
   - Real estate monetization
   - Developer based financing
   - Leasing
Questions?
Speaker Bio

Andrew J. Majka, Partner and Chief Operating Officer

Mr. Majka is a Partner and Chief Operating Officer with Kaufman Hall and has been with the firm since June 1993. In his tenure with Kaufman Hall, 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 healthcare financings and over $10 billion in derivatives.

Mr. Majka is a frequent speaker on healthcare 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 healthcare 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.

Kaufman, Hall & Associates, Inc.
5202 Old Orchard Road, Suite N700
Skokie, Illinois 60077
voice#: (847) 441-8780 x109, e-mail: amajka@kaufmanhall.com
www.kaufmanhall.com