Mergers & Acquisitions in the Hospital Industry

Since the beginning of 2010, mergers and acquisitions activity in the acute care sector has increased significantly. The rate at which hospital transactions are being announced has increased by over 50% in less than a year and a half. Activity is up significantly for both not-for-profit and for-profit healthcare systems. Internal discussions about potential consolidations, mergers, and acquisitions are also up dramatically.

This report looks at the factors and trends related to this increased activity level:

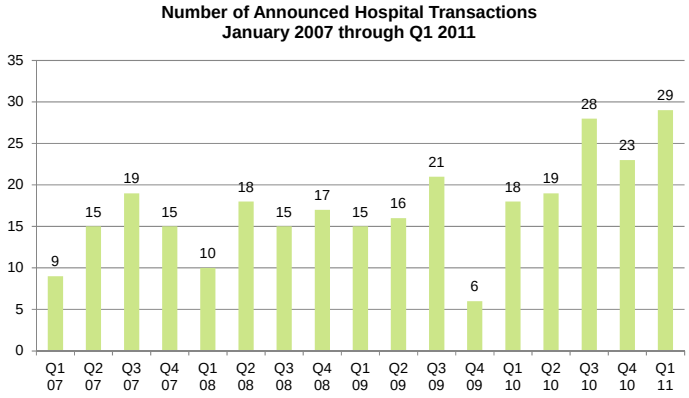
- Drivers of increasing transaction volume
- Specific trends within hospital M&A activity
- Valuation
- The response by not-for-profit healthcare systems
- Predictions for the balance of 2011

But First, What Had Been Holding Back Volume

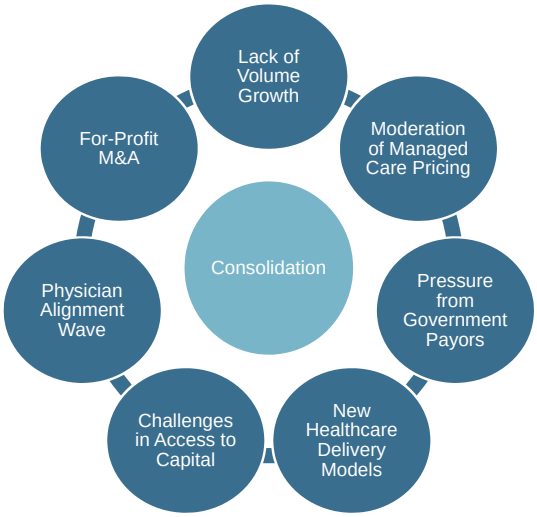
An increase in mergers and acquisitions has been expected for a number of years, but transaction volume was flat during 2007, 2008 and 2009 with 58 to 60 transactions announced each year. This level was significantly off the record levels witnessed in the mid-1990s when volumes reached over 150 transactions per year as Columbia HCA and others were active consolidators. During the 2007 to 2009 period, two big trends held back consolidation activity. First, in 2007 and 2008, debt was readily available at historically low interest rates and with liberal underwriting requirements providing incentive for the for-profit hospital companies to increase their use of leverage. Most notably, HCA and its private equity backers borrowed $28.0 billion of the total $33.3 billion purchase price to take the company private. This was one of the largest leveraged buyouts in history, and the debt used represented 85% of the purchase price, or 6.3 times debt-to-EBITDA (earnings before interest, taxes, depreciation and amortization). HMA announced a $2.4 billion special dividend to shareholders paid by the issuance of debt, leaving the company with significant leverage. Community Health Systems, outbidding private equity investors late in the process, acquired Triad Hospitals for $6.8 billion, of which $4.7 billion was raised through debt issuance. “Cheap” debt was plentiful, and for-profit hospital companies focused on using this leverage, rather than pursuing not-for-profit hospital and health system targets.

The second big trend that held back M&A activity, at least temporarily, was the financial crisis of 2008. The outcome of the crisis, in part, was that the tax-exempt debt markets were closed for a period during 2008 and altered for the foreseeable future. Amidst the crisis, not-for-profit healthcare systems clamped down on their capital expenditures and expansion plans. Their focus was dealing with troubled bond insurers, collateralizing derivatives and restructuring debt from variable-rate to fixed-rate. As a result, the focus on moving into new markets or adding new facilities was generally on hold for the not-for-profit healthcare systems.

Why Transaction Volume is Increasing



The two trends that previously held back activity are now driving consolidation and the increase in transactions since 2010. First, for-profit health systems have significantly reduced their debt levels over the past two years through improved operations and greater cash flow. The reduction has allowed for-profit health systems greater freedom and flexibility to raise additional capital for acquisitions. Second, while not-for-profits hospitals and health systems withdrew from the debt markets immediately after the financial crisis, strong organizations with high credit ratings have regained access to capital and can use these resources for strategic expansion. On the other end of the spectrum, for lower rated not-for-profit hospitals and health systems, capital continues to be scarce and more expensive. Many are unable to reinvest in operations and facilities, form new affiliation agreements with physicians or aggressively compete with neighboring hospitals. These organizations are now seeking alternatives through affiliations or partnerships.



As depicted above, there are a number of other key structural issues driving consolidation.

Lack of Volume Growth: Same store admissions growth for the publicly traded hospital companies as a group was negative in each quarter in 2010 with the final two quarters experiencing declines of over 2% versus comparable periods in 2009. The publicly traded hospital companies also witnessed a decline in total surgeries in each quarter of 2010 as well. Not-for-profit hospitals and health systems are experiencing similar volume challenges. Healthcare systems have made great strides on expense reductions and enhancement efficiencies, but it is very difficult to enhance the bottom line without growth in volume.

Moderation of Managed Care Pricing: Many hospitals and health systems experienced double-digit price increases from managed care payers during the 2000-2005 period. These increases masked issues related to volume challenges, and at the same time, strained companies' and individuals' ability to afford healthcare insurance. In the past few years, price increases from managed care have moderated to a more typical range of 5% to 7% with the likelihood that these increases will moderate further in the future. Historical reliance on rate increases to drive patient revenues is a risky proposition.

Pressure from Governmental Payors: Pressures on reimbursement from federal and state governments is already being felt. One example is in ancillary revenue related to physician cardiology practices. Medicare rates on these services have fallen as much as 30%, changing the economics for these services and leading many physicians to contractually align with health care providers. Clearly, state-funded reimbursement is a major concern of health care providers. Many states are currently contemplating, or have recently implemented, significant Medicaid rate cuts to meet state requirements and to attempt to balance budgets.

New Healthcare Delivery Models: Accountable care organizations, bundled payments, risk-based models, medical home—the list of new healthcare delivery models is growing. How these models will evolve is unclear, but all seem to focus on delivery of lower-cost, higher-quality health care. These models involve greater physician alignment, advanced information technology and structural innovation by healthcare systems.

Challenges in Access to Capital: In the first three months of 2011, as interest rates have risen and the window for temporary financing vehicles such as Build America Bonds has closed, new issuance volume of tax-exempt bonds is down over 50% as compared to the same period in 2010. In order to conserve capital and concentrate their efforts, some major not-for-profit systems are rationalizing their portfolios, exiting challenging markets and concentrating efforts where more successful. At the same time, access to capital for many for-profit issuers has improved in the past year, which may add potential capital sources for their acquisition plans.

Physician Alignment Wave: In our assignments with not-for-profit healthcare clients, physician alignment and recruitment has become a top concern, equal in many cases to the issue of access to capital. Acquisitions and employment of physicians have seen an increase that is even more dramatic than hospital M&A transactions. Over 50% of physicians are now employed, and the trend has not slowed. Those without the capital, information systems, and service line strength to attract and more formally align with physicians will be at a significant competitive disadvantage.

For-Profit M&A: For-profits hospital companies are the most active they have been in 15 years. More than 14 for-profit hospital management companies have announced transactions since the beginning of 2010. There are over 17 major private equity funds with investments in the hospital space. New platforms continue to be funded, such as RegionalCare (Warburg Pincus), Steward Health Care (Cerberus Capital), and most recently Ascension Health Care Network, a new for-profit company formed by Ascension Health and Oak Hill Partners. There appears to be no shortage of funding for these platforms. Private equity and public equity investors want exposure to healthcare and the

hospital space. As a result of this funding, along with the challenge in growing volumes and dealing with moderating reimbursement increases, for-profits are very busy pursuing acquisitions. Evidence is the pursuit of Tenet Healthcare by Community Health which would be one of the largest transactions in the healthcare sector ever. Finally, there has also been a pickup in unsolicited offers to not-for-profit systems with Steward Health's approach to Jackson Health in Miami, Florida, and RegionalCare's offer to Cheyenne Medical in Wyoming.

Trends in Hospital M&A

Return of Major Market, Not-for-Profit Hospital Transactions: Prior to 2010, the last major-market, multi-hospital sale of a not-for-profit system was in 2005 when Hillcrest Healthcare System was sold to Ardent Health Services. Since then, activity, in terms of similar transactions, had been quiet. But in 2010, two major transactions in the not-for-profit sector occurred as Detroit Medical Center sold to Vanguard Health and Caritas Christi sold to Steward Health Care. These examples involve systems that are distressed or significantly challenged, but in 2011 and 2012, larger, non-distressed systems will begin to consider their alternatives with greater frequency.

Rationalization of Portfolios: Both not-for-profit and for-profit systems have exited their more challenging markets. Transactions have been announced in both directions. In terms of for-profit divestitures, in early 2011, HCA announced the sale of Palmyra Hospital in Georgia to Phoebe Putney, and HMA announced the sale of Riley Hospital to Anderson Regional. Meanwhile, Catholic Health East announced the sale of Mercy Hospital in Miami to HCA in 2010, and Catholic Health Partners announced the sale of Mercy Health System in Scranton to Community Health Systems in early 2011. Financially healthy systems are looking for ways to strategically reduce their portfolios in underperforming markets and concentrate their efforts in more productive markets. On a more dramatic level, in light of physician ownership legislative changes, MedCath has announced that all of its facilities are for sale, and five of its facilities have been sold or are in the process of being sold.

Despite Increase in For-Profit Activity, Consolidation by Not-for-Profits Continues to Account for More Deal Volume. In 2008 and 2009, not-for-profits were the successor or acquirer in approximately two-thirds of announced M&A transactions. As discussed earlier, since early 2010, for-profit healthcare systems have become much more aggressive in pursuing acquisitions. However, not-for-profit healthcare systems have stepped up their activity level as well. The result is that for transactions announced from January 1, 2010 through the end of February 2011, not-for-profits continue to be the successor or acquirer for approximately two-thirds of all announced transactions.

New Not-for-Profit / For-Profit Partnerships Emerge: Such partnerships are not new. In the 1990's, the tax status implications of a significant joint venture between St. David's Health System in Austin, Texas, and HCA were tested by the IRS, but were ultimately successfully upheld. Since that time, healthcare systems have continued to pursue joint ventures across tax status. In the past year, HMA announced a new joint venture with Shands Healthcare, LHP announced a joint venture with Saint Mary's in Connecticut, LifePoint announced an alignment with Duke Health System to jointly acquire North Carolina community hospitals and Ascension Health announced a new potential model for Catholic healthcare delivery with private equity partner Oak Hill Partners. Not-for-profit systems do not currently have the same access to capital as their for-profit capital partners, but can expand their reach and networks through partnering.

What are Not-For-Profit Healthcare Systems and Hospitals Doing in Light of this Wave?

Not-for-Profits' Outlook is Gloomy: While equity research analysts covering for-profit hospital companies have looked at health care reform as a potential positive with expectations of lower numbers of uninsured and reduced bad debt expense, the not-for-profit world seems to be bracing itself for more difficult times ahead. To many not-for-profit healthcare executives, healthcare reform means reduced reimbursement. The credit rating agencies have a similar vantage point with Moody's reiterating its negative outlook in February 2011 for the not-for-profit healthcare industry and expecting difficult conditions to remain for at least the next several years.

Talk of Strategic Options is in Vogue: Prior to 2010, discussing strategic options was viewed by many as the equivalent of not-for-profit boards of directors' capitulation to putting hospitals up for sale. In light of current market activity, not-for-profit systems are much more open to discussing strategic alternatives. Many

are still unwilling to pursue formal options, but boards of directors increasingly want to understand their options and be ready in light of the challenges they face.

Picking Their Battles and Concentrating Their Efforts: As mentioned earlier, not-for-profit systems are exiting markets where they feel they cannot succeed and yet need to make major investments. This trend includes some of the top Catholic systems in the country, including Catholic Health Initiatives, Catholic Health East and Catholic Health Partners have exited certain markets during 2010 and 2011. Systems know they do not have unlimited capital and physician recruiting budgets, so they are rationalizing their facility portfolios.

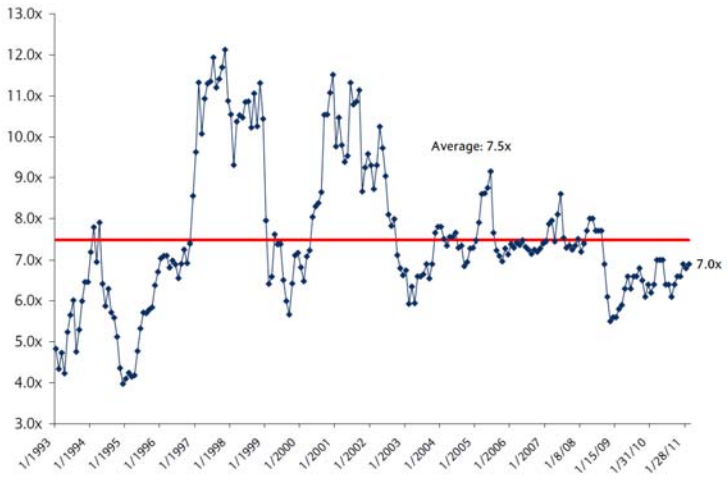
Not-For-Profits are Looking but Cautious: Systems continue to be proactive in pursuing opportunities that are synergistic with their existing facilities and markets. Tuck-in acquisitions in existing markets or market extensions continue to drive activity. For example, in January 2011, Methodist Healthcare System of San Antonio completed the acquisition of 120-bed Texsan Heart Hospital, also based in San Antonio, from MedCath Corporation and physician investors. Texsan became the ninth hospital in San Antonio for Methodist Healthcare, a joint venture of local Methodist Healthcare Ministries and HCA. Also, certain states, after experiencing less consolidation, are now seeing significant activity. Michigan had been relatively quiet in terms of hospital M&A prior to 2008, but now systems including McLaren and Spectrum have been very active. With only one for-profit hospital in the state prior to 2010, Vanguard bought Detroit Medical Center and created a new for-profit dynamic in the state.

Sound Standalone Systems are Deciding to Partner: Many hospitals or small systems that in the past were staunchly independent have decided to partner. Martha Jefferson Health in Virginia was an "A+" rated system with over 35% market share in an attractive Charlottesville, Virginia, market. Despite this position, Martha Jefferson announced a partnership with "Aa" rated statewide system Sentara Health. In another market, Health Central in Ocoee, Florida, is an "A" rated system with significant cash, low leverage, solid historical operating margins and a relatively new hospital. However, management and its board are concerned about the future, citing concerns about increasing pressures from healthcare reform, growing competition in the marketplace and the expanding needs of the local community. As a result, the system explored its strategic options and announced a potential affiliation with Orlando Health. For many years, hospitals partnered out of desperation or financial distress; now healthy hospitals also see the need to partner.

For Many, the Real Battle Ground is Physician Alignment: While capital continues to be a top concern, acquiring or employing doctors has often trumped facility acquisitions in terms of priority. The employment wave continues to gain momentum, and, increasingly, physician alignment is seen as the key to market strength. Despite the complexities of these alignment models and larger than expected related financial losses in many cases, physician employment and acquisitions remain essential to the future of healthcare systems.

How Does this Impact Hospital Valuations?

HCA went public again in March 2011 becoming one of the largest IPOs in healthcare history and capping a very successful equity return for its investors. HCA's timing would suggest that valuations for the sector are at historically high levels. However, although valuations have increased from recent troughs, valuations actually remain below historical average and well below all-time highs on an enterprise-to-EBITDA valuation basis. HCA's success hinged on significant use of leverage and a 33%+ increase in EBITDA from the time HCA went private in late 2007 to results for the year ended December 31, 2010.



Note: As of March 8, 2011.
Source: Barclays Capital, Reuters, FactSet.

But what are the latest trends in transaction values? While cash flow multiples are more sound in terms of financial principles and more readily available for publicly traded companies, EBITDA figures are often

hard to obtain due to a lack of publicly available data or, for many targets, EBITDA levels are depressed to the point that EBITDA multiples are less meaningful. Revenue multiples can often be translated into implied forward EBITDA multiples. For example, a for-profit system may pay 0.6x trailing net revenue, but it may be projecting that the valuation equates to 6.0x EBITDA for the first full year of operations under its ownership.

As the credit markets crashed in 2008 and valuations in the public markets fell, the market talk for acquisitions also began to suggest lower transaction valuations. On recent quarterly investor calls with equity research analysts, executives from publicly traded hospitals companies have talked about typical transaction valuation ranges of 0.5x to 0.6x net revenue. If we review data from the past 10 years, the average revenue multiple is approximately 0.75x net revenue.

So where are valuations today? We see a trifurcation of valuations. First, for distressed assets, the typical range is 0.2x to 0.4x net revenue. These situations may involve bankruptcies or situations where a facility has significantly cut back operations and is selling for base asset value—real estate or facility value with no credit for existing operations. Second, there is an "average" valuation range of 0.5x to 0.7x net revenue. Levin & Associates, a leading publisher of healthcare M&A data, reported that the average price-to-net revenue multiple in 2010 was 0.66x down from 0.78x for the prior year. So in a sense we agree with the guidance being given to the public equity markets although we see a slightly higher upper end of the "average range" mentioned by healthcare executives. However, these averages understate the third component of the trifurcation of valuations—outcomes for competitive situations or highly strategic assets. Despite their comments to Wall Street, for-profit systems—as well as not-for-profit systems in specific cases—have been willing to pay well beyond the 0.75x long-term average net revenue multiple for certain assets. With 14 well capitalized for-profit hospitals companies seeking acquisitions, there is high demand for acquisitions. But again, in order for these above-average transaction multiples to be achieved, the target hospital must be strategic or in-market with multiple potential acquirers.

Forward Looking Implications

- We expect M&A activity to continue to be very robust. The pressures leading to current consolidation trends show no signs of abating. Lack of volume growth, challenges in reimbursement, access to capital challenges, need for physician alignment, new healthcare models are all issues gaining in momentum, not lessening.

- When federal and state governments get serious about deficit reductions, the most serious wave of consolidations will undoubtedly begin. States are already reducing Medicaid reimbursement meaningfully in light of dire financial situations. The federal government will do the same at some point, and Medicare reimbursement will take a significant hit. Managed care will follow. With not-for-profit systems averaging a 2.3% operating margin according to Moody's latest data, there is little cushion for serious reimbursement cuts. In this environment, M&A activity will accelerate to levels even beyond what we have seen in 2010 and 2011.

- Hospital closures and distressed situations will also increase as many hospitals will have difficulty surviving. Financially justifying independent full-service hospitals with challenging market dynamics, especially those not strategic to other neighboring systems, will become more and more difficult. Many may be converted to outpatient facilities or urgent care centers.

- There will also be consolidation of for-profit platforms in the hospital sector. There are14 for-profit hospital management companies that are either publicly traded or have major private-equity backing. Lack of volume growth and moderating managed care pricing increases make producing expected returns on equity a challenge. Although the volume of targets for acquisition continues to grow, there are likely too many platforms looking for acquisitions. The result will be consolidation of a select number of these companies.

- Current valuation levels will remain firm during 2011 and into 2012 due to the large number of for-profit systems seeking acquisitions. This dynamic will also yield above-average valuations for assets with significant scale and market share. However, beyond 2012, transaction valuations may experience downward pressure as reimbursement reductions become pervasive and the number of acquirers is reduced through consolidation.