

No Margin – No Mission

- *Developing a Target Minimum Operating Margin*
- *MOM as a Board and Management Tool*

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Table of Contents

- 2** Executive Summary
- 3** “No Margin, No Mission”
- 4** Current Practice vs. Shattuck Hammond Approach
- 6** Target Minimum Operating Margin: Conceptual Approach
- 8** Target MOM
- 8** MOM and Operating Asset Productivity
- 9** MOM and Cost of Capital
- 12** The Unique MOM
- 14** MOM as an Organizational Tool
- 16** About Shattuck Hammond Partners

Executive Summary

Today's challenging operating environment has left many not-for-profit hospitals and hospital systems with negative operating margins. Other more fortunate organizations are left to compare operating results to those of an "underperforming" industry.

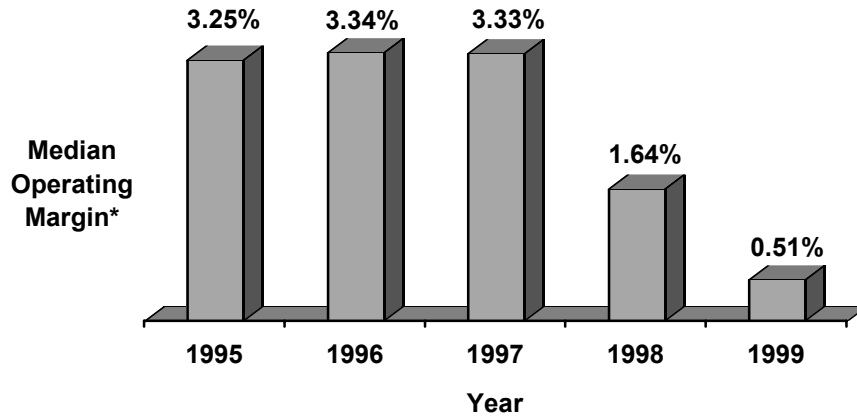
With the emergence of negative operating margin trends, mission and fiduciary issues have moved to the forefront of the Board-Management-Community dialogue. In this climate, not-for-profit organizations are searching for credible financial and operating targets that guide organizational action plans ranging from the more severe "restructuring" options to the less contentious "optimization" actions.

Shattuck Hammond Partners has developed the target Minimum Operating Margin or "MOM" approach to provide a much needed tool to permit Boards and Management to harmonize mission, business and fiduciary objectives.

The following report introduces MOM and its application in today's healthcare environment.

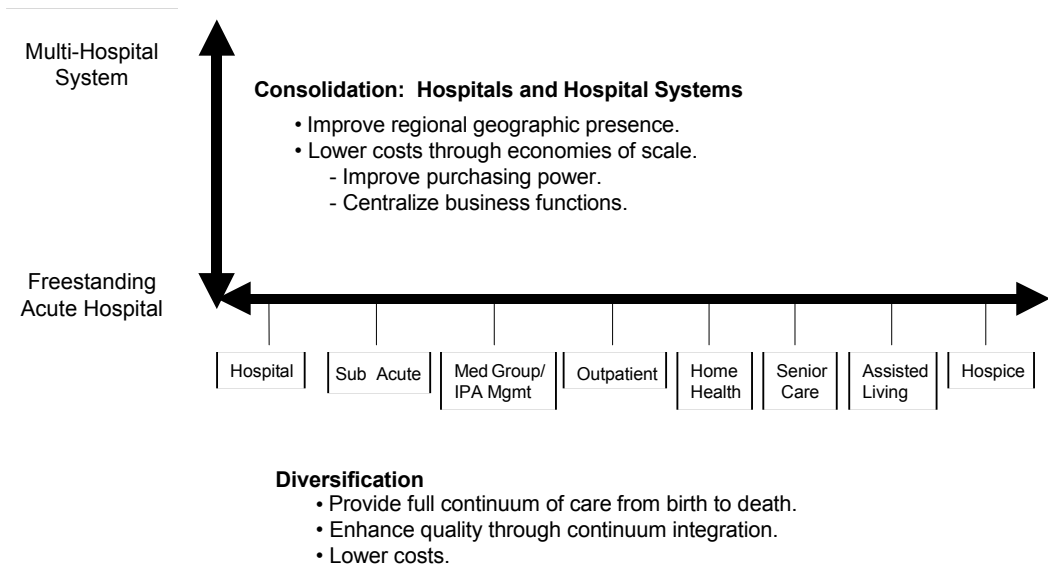
"No Margin, No Mission"

Developing an integrated approach to achieving often conflicting mission and margin objectives continues to challenge the not-for-profit hospital industry. This challenge has only intensified during the current period of declining operating margins.



*Source: Moody's Investors Service, "Not-For-Profit Health Care: 2000 Outlook and Medians."

Furthermore, a pricing and expense outlook that appears to augur a weak forecast for operating margins has flashed a clear and present danger signal for an industry that has recently completed an unprecedented phase of hospital consolidation and investment in service diversification (e.g. physician management services, home health, skilled nursing, sub-acute care, senior care, senior living, laboratory, and diagnostic). The mission/margin challenge has not only intensified but has become far more complex with the consolidation and diversification of the industry.



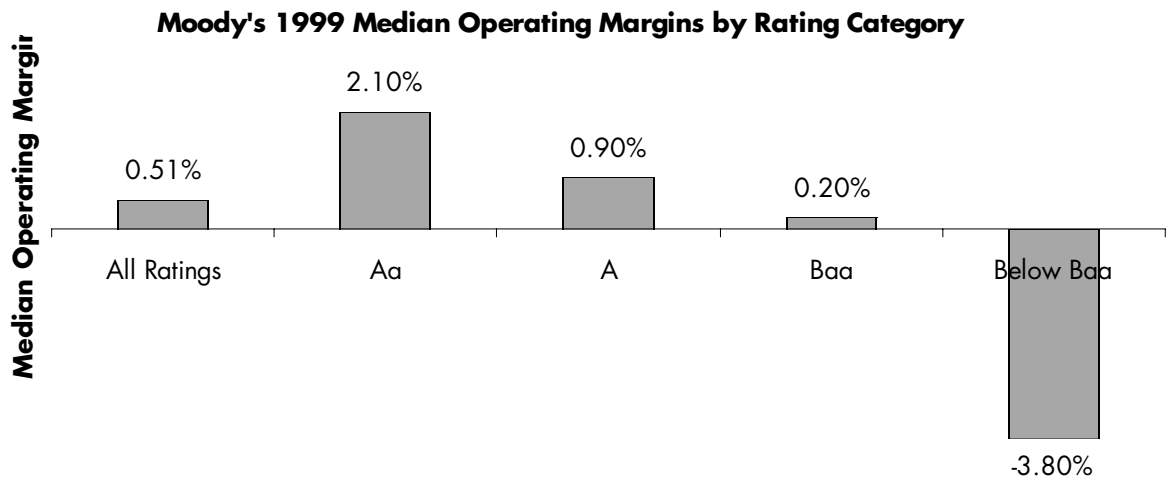
The phrase "no margin, no mission" is an often-repeated saying that aptly recognizes the practical importance of a positive margin in two significant ways: (1) to support charitable services that would otherwise not be offered and (2) to sustain economic viability in a highly capital intensive industry. This concept recognizes the fact that the mission and business are intertwined and, more fundamentally, that many aspects of the mission would not be possible without a viable business. The interdependency of mission and business in a not-for-profit hospital organization is further underpinned by the fiduciary responsibility that is conferred on the Board of Trustees and Management in operating business assets which, in legal fact, are part of a charitable trust. This charitable trust, as we are reminded by the Office of the Attorney General in numerous states, is created to pursue and fulfill a specific purpose as dictated by the organization's corporate bylaws. In most cases, this purpose is the same blend of pursuing a mission through operating a business.

The decision framework for making mission/business or business/mission decisions necessarily centers on the operating margin. The critical question then is to identify the operating margin target that would satisfy dual (or dueling) mission/business objectives and underlying fiduciary responsibilities. This theoretical target operating margin then would provide the basis for evaluating alternative action sets to produce the optimal mission/business outcome.

In this report Shattuck Hammond Partners proposes to add a new theoretical approach to incorporating business and mission objectives in the setting of an operating margin target. It is our hope that this approach will provide some practical tools for achieving mission/business harmony and, through its application, enhance our grasp of the choices that confront our not-for-profit hospital and health system clients today.

Current Practice vs. Shattuck Hammond Approach

Most not-for-profit hospital organizations set an operating margin target through a budget process. This budgeted target is finally approved by the Board of Trustees along with a set of secondary targets and management initiatives that are expected to produce the budgeted result. In the majority of cases, organizations rely on a peer standard to identify a target benchmark for operating performance. Frequently, this peer standard is based on credit standards (data from bond rating agencies) that provide a proxy for risk and a measure of capital access.



Source: Moody's Investors Service

Although the above standards, as an example, are useful in providing benchmark guidance, they are inadequate in three crucial ways. First and foremost, achieving these targets does not mean that a fiduciary standard is being met. Secondly, these "point in time" indications do not necessarily provide good long term targets. Lastly, these standards inherently lack comparability to the specific (and unique) financial and operating profile of an individual organization.

Shattuck Hammond's objectives in creating a new approach to deriving a target operating margin are to (1) incorporate an objective fiduciary standard; (2) provide a long term target and (3) provide a target that is tailored to an organization's specific financial and operating profile.

Target Minimum Operating Margin: Conceptual Approach

The first and keystone objective to address in creating a target minimum operating margin ("MOM") is to embed a fiduciary standard or assumption in the approach. To address this objective, we have started with the fundamental premise that **the target MOM should be set at a level that, as a minimum, sustains the value of the operating assets of the organization.**

In order for the operating assets of an organization to sustain their value, they must produce a return at least equal to their cost. The cost of operating assets is equivalent to the cost of capital used to fund those assets. This cost of capital is a combination of the cost of debt and the cost of equity capital – referred to as the weighted average cost of capital or "WACC."

Therefore, in order for operating assets to sustain their value they must generate a return on operating assets (before interest expense) at least equal to the cost of capital or WACC associated with those assets.

In order to express this minimum return on operating assets as a return on operating revenue and thus derive a target Minimum Operating Margin or "MOM," we have created the derivation on the facing page.

MOM Derivation	
Premise: In order to sustain its value, an organization's return on operating assets before interest expense ("ROABI") must be greater than or equal to its weighted average cost of capital ("WACC").	
<i>IF</i>	ROABI \geq WACC,
<i>AND</i>	ROABI = OIBI/A,
<i>AND</i>	ROABI = OIBI/R \geq WACC \geq I/R,
<i>THEN</i>	OIBI/R \geq WACC \geq I/R,
<i>AND</i>	OIBI/R \geq WACC \geq I/R.
<i>IF</i>	MOMBI = OIBI/R,
<i>SUCH THAT</i>	OIBI/R \geq WACC \geq I/R,
<i>THEN</i>	MOMBI = WACC \geq I/R
<i>AND</i>	MOM=[(WACC \geq I/R) - I/R] + Revenue Growth Factor*

ROABI : Return on Assets Before Interest Expense

WACC : Weighed Average Cost of Capital

OIBI : Operating Income Before Interest Expense

R : Operating Revenue

A : Operating Assets

I : Interest Expense

MOMBI : Minimum Operating Margin Before Interest Expense

MOM : Minimum Operating Margin

***Revenue Growth Factor :** $(g + I/R)$ where "g" equals annual revenue growth rate

Note: Many not-for-profit organizations employ debt financing strategies that reflect levels of liquid non-operating investment assets. WACC and I/R should be calculated based on debt capital that is allocated to operating assets.

MOM calculations require many subtle and complex definition and approach decisions that can strongly affect results. Contact Shattuck Hammond Partners for further details.

Target MOM

$$\text{MOM} = [(\text{WACC} \cdot \text{A/R}) - \text{I/R}] + \text{Revenue Growth Factor}$$

MOM provides a long term target for at least sustaining operating asset value. Although the variables that comprise MOM do change over time, these key variables are generally not subject to significant volatility on a short term basis. In order to thoroughly understand MOM and its strategic and operating implications, we need to further explore the primary variables that drive MOM, namely asset productivity (A/R) and cost of capital (WACC).

MOM and Operating Asset Productivity

Intuitively, it is not surprising that operating asset productivity affects MOM in a clear and direct fashion. In our MOM formula, operating asset productivity is expressed as operating assets divided by operating revenue or A/R. This ratio amounts to the operating assets required to generate \$1 of operating revenue. As such, a lower A/R ratio means higher asset productivity. Returning to the MOM formula, higher asset productivity (lower A/R) has the effect of lowering our target MOM. Stated in plain English, the higher the operating revenue base that is created from the operating assets, the lower the operating margin required to cover the cost of capital associated with those assets.

Example

Neutral	A/R = 1	WACC = 6%	MOMBI = 6%
Lower productivity	A/R = 1.20	WACC = 6%	MOMBI = 7.2%
Higher productivity	A/R = 0.80	WACC = 6%	MOMBI = 4.8%

Operating margin and asset productivity go hand-in-hand in evaluating the relative performance of a particular operating asset. In our experience, however, very few health systems measure or track operating asset productivity. Given the current environment of depressed operating margins and capital requirements that often exceed funding capability, **operating asset review processes should represent a major area of focus for management teams and Boards.** MOM provides a valuable context for conducting comprehensive operating asset reviews.

MOM and Cost of Capital

Cost of capital is, of course, directly related to MOM. A higher cost of capital requires a higher MOM to sustain operating asset value.

Cost of capital or WACC is determined by the cost of debt and equity and by the relative proportion of debt and equity that comprise an organization's capital structure. The formula for WACC is detailed below.

Although our formula for WACC is clear, defining WACC for a not-for-profit organization is anything but clear. Given the direct dependence of MOM on an organization's calculated WACC, it is critical to understand the full spectrum of approaches to calculating WACC along with their respective philosophical rationales.

Mission factors once again enter the target MOM discussion in the context of defining an appropriate WACC. Mission is a factor because not-for-profits have a lower subsidized cost of capital or WACC which presumably permits not-for-profit hospital organizations to bear the mission-related operating expenses which in return lower operating margins. Our MOM formula demonstrates that a lower WACC results in a lower MOM. **However, without quantifying specific mission expenses that are embedded in the operating margin, it is impossible to know whether operating margin is lower due to mission factors or whether the organization is simply under-performing.** The only direct way to address this mission-margin issue is to develop a suitable approach to quantifying those mission-related expenses that are embedded in operating expense and that would not otherwise be incurred in a for-profit setting.

Weighted Average Cost of Capital
$\text{WACC} = (K_d (1-t) \frac{D}{D+E}) + (K_e \frac{E}{D+E})$
K_d = current market cost of debt
K_e = expected equity return
E = market value of equity
D = market value of debt
t = marginal corporate tax rate (zero for NFP organizations)

For purposes of illustration in this report, we have shown a range of cost of capital calculations that could be utilized by not-for-profit hospital organizations. Each of these approaches has its strengths and weaknesses – the approach or combination of approaches that is/are finally selected by an organization should reflect a thorough understanding of the underlying principles behind the approach(es).

On the facing page, we have calculated WACC for an "A" rated hospital organization using three alternative scenarios and assuming a constant debt to capital ratio. The first scenario, which produces the lowest cost of capital, fully incorporates the mission subsidy by using the tax-exempt cost of debt and an assumed cost of equity equal to zero. These assumed capital costs are intended to represent the actual fully subsidized cost of capital of a not-for-profit organization.

The next scenario incorporates a partial subsidy by utilizing a subsidized tax-exempt cost of debt and by assuming a cost of equity equivalent to a long term expected investment return on a balanced investment portfolio (which would be similar to a return assumed on a pension fund). This equity rate assumes a partial subsidy because the risk-adjusted expected equity rate of return (as represented by publicly traded hospital companies) would be much higher.

Finally, the "no subsidy" scenario assumes a taxable cost of debt and a for-profit publicly-traded hospital company cost of equity. This scenario produces the highest cost of capital of 9.78%.

Cost of Capital Scenarios For an "A" Rated Organization

Scenario	Approach	Cost of Debt (K_D)	Cost of Equity (K_E)	Cost of Capital (WACC)⁵
Full subsidy scenario	Actual tax-exempt debt cost; equity return is applied to and covers mission costs included in operating expense.	6.40% ¹	Zero ²	2.37%
Partial subsidy scenario	Actual tax-exempt debt cost; opportunity cost of investment as proxy for cost of equity (K_E).	6.40% ¹	8% ³	7.41%
No subsidy scenario	Taxable debt cost, For-profit public company cost of equity (K_E).	8.90% ¹	12.38% ⁴	9.78%

¹ Source: Shattuck Hammond Partners (April, 2001)

² Assumes equity return is totally applied to and fully covers mission operating expenses.

³ Assumed long term rate of investment return on "balanced" portfolio.

⁴ Source: Ibbotson median CAPM cost of equity capital for hospitals (SIC Code 806) as of September, 2000.

⁵ Based on 37% debt to capitalization ratio for Moody's median 1999 "A" Rated Hospital.

Note: The above cost of capital scenarios are illustrated only for purposes of estimating MOM. Approaches used to develop investment hurdle rates, value business enterprises or design capital structure may differ.

On the facing page we have calculated MOM for an "A" rated organization using our alternative cost of capital scenarios. **Under the full subsidy scenario, MOM would be comparable to a required operating margin reflecting full application of the tax-exempt debt and zero equity return subsidy to cover operating mission expense. This scenario assumes that the full subsidy is enough to cover mission operating expense.** The full subsidy scenario results in a modest MOM of 2.89% which nonetheless is well above the actual 1999 median A-rated hospital Moody's operating margin of 0.9%. **In the context of our MOM definition, the median A-rated hospital is not meeting a minimum fiduciary performance standard and is in fact operating at a level which is devaluing its charitable operating assets.**

The partial subsidy scenario results in a MOM that would maintain operating asset value under circumstances which required a conservative (low) rate of return on equity. This scenario reflects the intuitive view of many trustees of not-for-profit hospital boards. These trustees expect to serve their mission and produce a positive return that enhances value and makes the organization stronger in the future.

Our last scenario, the "no subsidy" scenario, yields a MOM that would be comparable to a pre-operating mission expense operating margin. The striking aspect of this no subsidy MOM is that it is almost 7% above the "full subsidy" scenario in this example.

The Unique MOM

Every organization will have a unique MOM that is dependent on its asset productivity, assumed cost of capital and capital structure, current interest expense, and projected operating revenue growth rate. Furthermore, the philosophical underpinnings of selecting an approach to calculating MOM (or a range of MOM's) will also differentiate each organization's MOM.

Cost of Capital and MOM for an "A" Rated Hospital Organization

Scenario	Cost of Capital (WACC)	MOM	Comments
Full subsidy scenario	2.37%	2.89%	Assumes operating mission expense is fully incorporated in operating margin.
Partial subsidy scenario	7.41%	7.47%	Allows for partial subsidy to cover operating mission expense but still expects return on operating assets above inflation rate.
No subsidy scenario	9.78%	9.63%	Would apply to target operating margin if margin were adjusted to eliminate operating mission expense that would have otherwise not been incurred in a for-profit setting.

MOM as an Organizational Tool

Shattuck Hammond Partners believes that MOM can provide a highly valuable framework for incorporating trustee and management guidance, communication and education into the formation of an organization-wide operation margin target which can in turn be utilized to guide an organizational action plan (See facing page). This MOM framework will perhaps be most valuable for those organizations possessing a target MOM that is far above actual operating margin performance. These organizations will have extensive restructuring needs, which will create the most intensive and complex set of mission/business decision challenges.

The more fortunate organizations that have a MOM target below or within reach of their current operating margin performance will also find MOM to be a useful tool. For these organizations, MOM can provide a framework to maintain or enhance performance and to clarify Board of Trustee and management goal-setting and decision-making processes.

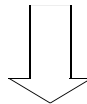
MOM as an Organizational Tool

MOM
<ul style="list-style-type: none"> ▪ Concept ▪ Philosophy ▪ Education



Board of Trustees

- Establish fiduciary expectations
- Develop operating target that fulfills fiduciary responsibility
- Manage mission/business decision framework



Action Planning Framework

Strategies	Mission Strategies	Asset Strategies	Capital Strategies	Operating Strategies
Goals	<ul style="list-style-type: none"> ▪ Improve resource effectiveness ▪ Manage cost 	<ul style="list-style-type: none"> ▪ Improve asset productivity 	<ul style="list-style-type: none"> ▪ Lower cost of capital (WACC) 	<ul style="list-style-type: none"> ▪ Improve operating margins
Actions	<ul style="list-style-type: none"> ▪ Develop capability to track and quantify mission operating expense 	<ul style="list-style-type: none"> ▪ Conduct asset review ▪ Develop divestiture plan ▪ Develop acquisition plan 	<ul style="list-style-type: none"> ▪ Define target credit rating ▪ Prepare strategic capital plan ▪ Develop financing approach 	<ul style="list-style-type: none"> ▪ Productivity benchmarking ▪ Operational restructuring ▪ Technology strategies



ACTION PLAN

About Shattuck Hammond Partners

Shattuck Hammond is an investment banking firm that specializes in providing a full range of investment banking services to healthcare service companies upon request. Shattuck Hammond is prepared to offer many of the services that are crucial to developing a MOM-based action plan. These services include:

- MOM education for Boards and Management
- MOM application studies
- Asset review and analysis
- Divestiture planning and implementation
- Acquisition planning and implementation
- Strategic capital planning
- Financing plan development
- Debt financing
- Private equity financing (for taxable entities)

To learn more about Shattuck Hammond Partners, visit our website at www.shattuckhammond.com or contact one of the investment bankers listed below in our offices across the United States.

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