SG Cowen

Acute Care

Industry Review

Outlook For Acute Care Acquisitions Remains Favorable

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Conclusion: Our recent conference call on acute care hospital acquisitions confirmed our view that acquisitions will remain an important contributor to public-company revenue and earnings growth. For now, difficulties with sluggish volume growth and bad debt keep us cautious on the group.

- **Market Share, Expense Control Determine Acquisitions' Success.** Our speaker highlighted market share (20%+ preferably) and expense reduction opportunities (labor and supplies) as the biggest determinants.
- **Pool Of Potential Non-Profit Acquisition Candidates Is Large.** Many non-profits lack the management resolve or financial flexibility to address expense pressures and meet capital needs, and will continue to seek partners.
- **Non-Profit Acquisitions More Attractive.** Our speaker questions the wisdom of for-profits buying hospitals from each other. Investors should scrutinize these deals closely since for-profits generally are well-managed.
- **Valuations Have Not Changed, But Exceptions Occur.** Multiples remain 5-6x pro forma EBITDA, or less than 1x revenue. HCA's acquisition of Health Midwest is the most notable exception. Some exceptions make sense (in-market deals), but require extra scrutiny.
- **UHS's Recent Deals Best Fit The High-Success Template.** The purchase of Vista Health offers margin improvement opportunities and recent acquisitions in New Orleans enhance the company's presence there.

SG Cowen Acute Care Universe

Company	Ticker	Price	Mkt. Cap.
HCA	HCA	$41	$20B
Health Management Assoc.	HMA	$22	$5.3B
LifePoint Hospitals	LPNT	$33	$1.2B
Tenet Healthcare	THC	$12	$5.3B
Triad Hospitals	TRI	$33	$2.4B
Universal Health Services	UHS	$46	$2.7B
Not Covered			
Community Health Systems	CYH	$27	$2.7B
Province Healthcare	PRV	$16	$0.8B

SG Cowen Provider Universe Financial Performance Analysis

	Ticker	FY	Price 3/4/04	52 Week Range	Shares Out.	Market Cap (MM)	Calendar EPS 2003	Calendar EPS 2004E	Calendar EPS 2005E	EPS Growth 2004	EPS Growth 2005	Calendar P/E 2004	Calendar P/E 2005	Enterprise Value/ Ann. Revs (a)	Enterprise Value/ Ann. EBITDA (a)	Price Performance 2002	Price Performance 2003	Price Performance YTD:04
Acute Care																		
HCA	HCA	Dec	$41	$27-52	495.5	$20,489	$2.62	$2.90	$3.25	+11%	+12%	15.8x	14.3x	1.3x	8.3x	+8%	+4%	(4%)
Health Mgmt Associates	HMA	Sep	22	16-26	242.8	5,288	1.18	1.45	1.63	+23%	+13%	18.5x	15.0x	2.0x	10.4x	(3%)	+34%	(9%)
LifePoint Hospitals [1]	LPNT	Dec	33	17-38	37.2	1,240	1.62	1.90	2.21	+17%	+16%	20.6x	17.5x	1.6x	7.7x	(12%)	(2%)	+13%
Tenet Healthcare	THC	Dec	12	11-53	464.8	5,540	0.38	(0.05)	0.17	N/A	N/A	31.5x	NM	0.7x	NM	(58%)	(2%)	(26%)
Triad Hospitals	TRI	Dec	34	20-42	75.3	2,538	1.73	2.30	2.70	+33%	+17%	19.5x	14.7x	1.0x	7.8x	+2%	+12%	+1%
Universal Health	UHS	Dec	47	32-58	58.0	2,699	3.10	2.68	3.03	(13%)	+13%	15.0x	17.3x	0.9x	7.1x	+5%	+19%	(13%)
Total/Average						**$37,795**				**+14%**	**+14%**	**20.1x**	**15.8x**	**1.2x**	**8.3x**	**(10%)**	**+11%**	**(6%)**
Clinical Labs																		
Quest Diagnostics	DGX	Dec	$82	$47-86	104.0	$8,535	$4.12	$4.78	$5.42	+16%	+14%	19.9x	17.2x	2.0x	10.0x	(21%)	+28%	+12%
LabCorp	LH	Dec	39	22-41	143.1	5,579	2.23	2.48	2.74	+11%	+10%	17.5x	15.7x	2.2x	9.8x	(43%)	+59%	+6%
Total/Average						**$14,114**				**+14%**	**+12%**	**18.7x**	**16.5x**	**2.1x**	**9.9x**	**(32%)**	**+44%**	**+9%**
PBMs																		
AdvancePCS* [1]	ADVP	Mar	$72	$22-65	93.1	$6,698	$2.08	$2.53	$2.92	+22%	+15%	34.6x	28.4x	0.4x	14.6x	(24%)	+138%	+36%
Caremark Rx	CMX	Dec	34	12-31	266.1	8,949	1.10	1.37	1.75	+24%	+28%	30.6x	24.6x	0.9x	13.5x	+3%	+56%	+33%
Express Scripts [1]	ESRX	Dec	75	40-75	78.5	5,884	3.20	3.91	4.80	+22%	+23%	23.4x	19.2x	0.4x	11.3x	+3%	+38%	+13%
Total/Average						**$21,531**				**+23%**	**+22%**	**29.5x**	**24.1x**	**0.6x**	**13.1x**	**(6%)**	**+77%**	**+27%**
Post Acute																		
RehabCare Group [2]	RHB	Dec	$22	13-26	16.1	$348	$1.08	$1.32	$1.48	+22%	+13%	20.0x	16.4x	0.6x	6.9x	(36%)	+11%	+2%
Select Medical [2]	SEM	Dec	16	6-19	100.8	1,594	0.72	1.00	1.22	+38%	+23%	22.0x	15.9x	1.1x	7.9x	(16%)	+141%	(3%)
United Surgical Partners [1, 2]	USPI	Dec	38	13-39	27.4	1,034	1.06	1.34	1.65	+26%	+23%	35.6x	28.2x	2.6x	11.5x	(26%)	+114%	+13%
Total/Average						**$2,976**				**+29%**	**+20%**	**25.8x**	**20.2x**	**1.4x**	**8.8x**	**(26%)**	**+89%**	**+4%**
Hospice																		
Odyssey HealthCare [1, 2]	ODSY	Dec	$20	$11-37	36.3	$737	$0.83	$1.03	$1.25	+24%	+22%	24.5x	19.7x	2.5x	11.9x	+34%	+91%	(31%)
VistaCare [1, 2]	VSTA	Dec	29	13-40	15.8	455	0.76	1.06	1.35	+39%	+28%	37.8x	27.2x	2.3x	15.0x	+33%	+118%	(18%)
Total/Average						**$1,191**				**+31%**	**+25%**	**31.1x**	**23.5x**	**2.4x**	**13.4x**	**+33%**	**+105%**	**(24%)**
CROs																		
Inveresk Research [1, 2]	IRGI	Dec	$28	$12-29	37.8	$1,052	$1.07	$1.30	$1.54	+22%	+18%	26.1x	21.3x	3.3x	16.3x	+66%	+15%	+12%
Total/Average						**$1,052**				**+22%**	**+18%**	**26.1x**	**21.3x**	**3.3x**	**16.3x**	**+66%**	**+15%**	**+12%**
S&P 500 *			**$1,152**				**$54.66**	**$61.10**	**$66.72**	**+12%**	**+9%**	**21.1x**	**18.8x**			**(23%)**	**+26%**	**+4%**

1 SG Cowen makes a market in these securities. [2] SG Cowen acted as a manager an offering of these securities in the last three years. (a) = Latest quarter annualized. *First Call estimates

Source: SG Cowen

Background

The SG Cowen Health Care Team's weekly client conference call recently addressed the acquisition market for acute care hospitals. Even without the backdrop of Tenet's latest divestiture plan, this topic is always timely because acquisitions account for a significant portion of acute care companies' growth rates. Our speaker was Joshua A. Nemzoff, president of Nemzoff & Company, LLC, which advises non-profit hospitals for sale and for-profit companies in purchases. Mr. Nemzoff's biography is attached.

Discussion Highlights

Inadequate Market Share And Expense Control Lead To Sales

Our speaker highlighted rising expenses (malpractice insurance and labor); managed care pressures; and growing capital needs as the drivers of sale decisions. In addition, most non-profit hospitals' managements lack the will to cut expenses (mainly labor and supplies) to generate an adequate margin for long-term survival. A hospital or system with less than 20% market share faces difficulty in negotiating with managed care companies. The for-profit companies have tighter labor management strategies (flexible vs. level staffing) and lower supply costs. Our speaker noted that HCA-led HealthTrust Purchasing Group's and Tenet Healthcare-led Broadlane's costs are usually 10% below those of non-profit GPOs Novation, VHA, and Premier.

The Pool Of Potential Acquisitions Remains Large

Our speaker noted that only 400-500 non-profit hospitals carry investment grade debt ratings and have EBITDA margin of 10.5%, ensuring long-term survival. We would add that many government-owned hospitals lack the capital to replace or update their facilities, and loathe raising taxes to finance capital needs. Recent examples include Community Health Systems' purchase of Southside Regional Medical Center (Petersburg, VA), and Province Healthcare's pending deal with Memorial Medical Center (Las Cruces, NM). In addition, many multistate or multimarket non-profit systems have sold hospitals to strengthen their portfolios. Examples include HMA's purchase of two hospitals from Providence Health (WA), and LifePoint Hospitals' purchase of two hospitals from Carraway Methodist (AL). For-profit hospitals account for only 16% of the entire acute care industry.

For-Profit Conversions And Penetration

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Number	8	7	3	13	10	12	9	25	63	50	29	19	17	19	38	20
Penetration	14%	14%	14%	15%	14%	14%	14%	14%	15%	16%	14%	14%	14%	15%	16%	16%

Source: The Community Impact of Hospital Mergers And Conversions, Project HOPE and Modern Healthcare
Penetration data from American Hospital Association and SG Cowen estimates (2003).

Mr. Nemzoff is optimistic about Tenet's ability to find buyers for its latest divestitures. We are less optimistic because several hospitals (in New Orleans and St. Louis) are losing tens of millions of dollars each. California's seismic standards and minimum nurse staffing rules have sucked significant value out of those assets. In California, most of the likely buyers lack adequate capital to pay much for these

facilities. The Brownsville, TX, hospital is the only gem in the group. We agree that the remaining core 69 hospitals have good prospects, but think the stock adequately reflects their long-term potential.

Can You REALLY Run It Better? Non-Profits More Attractive

Mr. Nemzoff's strongly held view is that acquisitions of for-profit hospitals are higher risk than acquisitions of non-profit hospitals. In his opinion, the for-profit companies (even Tenet Healthcare) have sophisticated managements and their facilities have fewer improvement opportunities. In these cases, investors should ask the buyer for details regarding areas of improvement. In-market deals are the one exception, where increased market share and cost efficiencies can drive improvements. Both Triad Hospitals and Health Management Associates bought hospitals from Tenet Healthcare last year. Even though the hospitals' margins deteriorated during the sale process and both companies have outlined areas for improvement, we think Triad has the lower-risk deal:

- Triad likely paid <7x trailing EBITDA while HMA paid closer to 8x; and
- Triad's purchases are in Arkansas while HMA's are geographically dispersed.

Recent Acquisition Activity By For-Profit Companies

		Number of Acquired Hospitals						
		Purchases, Net of Sales						
Company	Owned*	Q2:03	Q3:03	Q4:03	Q1:04	Pending	Goal	Comment
HCA	189	0	(1)	0	(1)	0	0	Sold New Orleans hospital to UHS
Tenet Healthcare	97	0	0	(11)	(1)	(28)	0	Selling 28 hospitals and closing one: only 1 obviously attractive target
Cmmnty Hlth. Syst.	72	0	3	0	0	2	2-4	LOI in Galesburg, IN and pursuing Chester, SC, hospital
Health Mgt. Assoc.	52	0	3	5	0	0	2-4	Acuired five hospital from Tenet plus hospital in GA
Triad Hospitals	50	0	0	7	0	(4)	1-2	Five sales pending plus potential JV in Ohio; 2 JVs in process (AR, NC)
LifePoint Hospitals	29	0	1	0	0	0	1-3	Stepping up acquisition search after quiet 2003
Universal Health	30	0	0	0	5	0	1-2	Bought Vista Health (3), Pendleton Memorial, and Lakewood Med. Ctr.
Province Healthcare	20	0	0	0	(1)	1	2-4	Acquisition of Las Cruces, NM, hospital pending
IASIS Healthcare	15	0	0	0	1	0	N/A	Bought Tenet's Las Vegas hospital
SunLink Healthcare	8	0	2	0	0	0	0	Received bid from start-up Attentus Healthcare
Vanguard Hlth. Syst.	16	0	0	0	0	2	N/A	JV with Penn buying Chestnut Hill Health; THC overlaps in Orange Cty.
Essent Healthcare	5	0	0	0	1	0	N/A	Bought CHRISTUS Health's operations in Paris, TX
Ardent Hlth. Svcs.	6	0	0	0	0	0	N/A	No word since pursuing Dimensions Health System in VA
Total	**589**	**0**	**8**	**1**	**4**	**(27)**	**9-19**	**Don't expect Tenet sales to be a significant source of targets**

*Acute care hospitals only. Source: Company reports + Includes transactions closed on October 1

Valuations: Not Much Change, But Exceptions Occur

Acquisition multiples have generally been within historical ranges. Buyers estimate the pro forma margin of the acquisition target based on its operating model (which tend to be very similar across companies), and apply a multiple of 5-6x pro forma EBITDA to determine the price. In most cases, this should result in a price/revenue multiple of less than 1x revenue. In many cases, the hospital has multiple bidders, so the acquisition multiple rises to 7-8x pro forma EBITDA, which reduces the potential accretion for the buyer. Variables such as market share, population growth, service mix, and payer mix will influence the potential margin, so understanding these factors is important. See page 6 for more complete data.

Price/Revenue Multiples By Year

2000	2001	2002	2003
0.89x	0.77x	0.79x	0.93x

Source: SG Cowen

Our speaker also cited the need to include future capital commitments as part of the purchase price. Our methodology adds capital commitments in excess of 4% of revenue (maintenance) and discounts these amounts at 10% and adds this amount to the purchase price. HCA's purchase of Health Midwest was cited as an expensive deal with $850MM upfront plus $450MM in capital commitments over five years. As a result, the price is $1.2B, or 1.3x revenue.

UHS's Recent Buys Best Fit The Preferred Template

UHS paid 6.3x trailing EBITDA for three-hospital Vista Hospital Systems. This valuation does not include the elimination of $4MM of corporate overhead (lowering the multiple to 5.3x EBITDA) and provides some cushion for potential competitive pressures in San Luis Obispo and the addition of property taxes. Vista generated EBITDA of $19MM in 2002, a 10.4% margin. After adjusting for bankruptcy costs, we think operating results were stable during 2003. The company also bought 90% of Pendleton Memorial Methodist and Lakeland Medical Center (from HCA) in New Orleans. The purchases bulk up UHS's operations in east New Orleans, fitting the industry's preferred template for acquisitions.

Vista Hospital Systems 2004E ($MM)

	Base Case	Eliminate Overhead	Comment
Revenue	$170	$170	No revenue growth
EBIT	13	17	$4MM of overhead
Interest	7	7	$120MM at 6%
Pretax	$5	$10	
Income Taxes	$2	$4	36.5%
Net Income	$3	$6	
EPS/Shares	**$0.05**	**$0.09**	65.8

Sources: Vista Hospital Systems, SG Cowen estimates

Multiples Paid In Recent Acquisitions ($MM)

Company	Hospital	Price	Rev.	Price To Revenue	Comment
2003:					
Community	Pottstown Memorial Medical Center*	$102	$115	0.89x	7% EBITDA margin; $20MM for capital
Community	Methodist Healthcare (7)	150	150	1.00	Pd. 6x estimated EBITDA of $25MM
Community	Southside RMC	90	122	0.74	5% EBITDA margin; replace by 2008
Community	Mercy Medical Center	129	160	0.81	6-7% EBITDA margin
HCA	Health Midwest (12 hospitals)*	1,232	950	1.30	Pricey with $450MM, 5-year capital deal
HMA	Madison County Medical Center	8	10	0.80	Lost $1MM in 2001
HMA	Providence Health (2 hospitals)*	85	125	0.68	Unprofitable; capital commitment is routine
HMA	Walton Medical Center	40	35	1.14	Purchase price not confirmed
HMA	*Tenet Healthcare (5 hospitals)*	*550*	*400*	*1.38*	*About 8x EBITDA assuming 16-17% margins*
LifePoint	Norton Spring View Hospital	16	21	0.73	$2.4MM EBITDA in 2001
Triad	*Tenet Healthcare (4 hospitals)*	*175*	*250*	*0.70*	*EBITDA margin at least 8%; multiple < 8x*
Triad	Woodward Regional Hospital	7	10	0.66	4% EBITDA margin in 2002
UHS	Vista Hospital Systems (3 hospitals)	120	182	0.66	6x EBITDA of $20MM
UHS	Pendleton Memorial Methodist	120	120	1.00	Pd. $108MM for 90%; 7-8% EBITDA margin
Vanguard	Baptist Health System*	355	420	0.85	$42MM operating loss
2002:					
Ardent	St. Joseph's Health System	$109	$160	0.68x	Negative EBITDA (1999)
Ardent	Lovelace Health System	211	380	0.56	$5MM EBITDA (2000)
Community	Plateau Medical Center	10	16	0.59	Lost $1.5MM in 2001
Community	Lock Haven Hospital	12	23	0.52	Negative margin
Community	Helena Regional Medical Center	21	22	0.95	Breakeven in 2001
Community	Memorial Hospital of Salem County	35	44	0.80	Negative EBITDA (2001)
Community	Lake Wales Medical Center	25	28	0.89	Price estimated; no margin data
Essent	Sharon Hospital	16	35	0.46	Negative margin
HCA	*Northern VA Community Hospital*	*28*	*35*	*0.80*	*Negative EBITDA*
HMA	*Three Clarent hospitals*	*130*	*138*	*0.94*	*Estimated EBITDA of $11MM*
HMA	*Mesquite Community Hospital*	*80*	*60*	*1.33*	*Pd. 8-9x EBITDA; sold 20% to HCR*
LifePoint	Russellville Hospital	19	27	0.70	Negative EBITDA (2001)
LifePoint	Carraway Methodist (2 hospitals)	22	38	0.58	Negative EBITDA (2001)
LifePoint	Logan General/Guyan Valley Hospitals	88	75	1.17	5% EBITDA margin (2001)
Tenet	Roxborough Memorial Hospital	24	46	0.52	Negative EBITDA (2000)
UHS	*Lancaster Community Hospital*	*40*	*52*	*0.77*	*8% EBITDA margin in 2001*
UHS	North Penn Hospital	30	40	0.75	Negative EBITDA (2001)
2001:					
Community	South Texas Regional Med. Ctr.	$28	$27	1.04x	Good margins: price 6.8-7.0x EBITDA
Community	St. Elizabeth Medical Center	42	65	0.65	Break-even EBITDA
Community	Red Bud Regional Hospital	5	16	0.31	Negative EBITDA (1999)
HMA	Lee County Community Hosp.	22	19	1.16	Bankrupt, price looks high
HMA	Carlisle Hospital	43	63	0.68	3-4% margin; replace within 5 years
LifePoint	*Athens Regional Med. Ctr.*	*20*	*25*	*0.80*	*EBITDA margin 7-9%*
LifePoint	Ville Platte Medical Center	21	21	1.00	Includes $10-12MM capital over 3 years
Province	Lakewood Medical Center	15	20	0.75	Long-term lease
Province	Med. Ctr. of Southern Indiana	16	20	0.80	No details on profitability
Province	Vaughan Regional Med. Ctr.	28	38	0.74	Negative EBITDA (1999)
Province	Selma Baptist Hospital	31	36	0.86	Breakeven or negative EBITDA
Province	Ashland Regional Medical Ctr.	4	21	0.19	Bankrupt, could need capital
Tenet	South Fulton Medical Center	30	85	0.35	Bankrupt, unprofitable
Tenet	St. Alexius Medical Center	26	42	0.62	Unprofitable
Tenet	Daniel Freeman Hospitals	90	175	0.51	Includes $55MM capital over 10 yrs.
Tenet	Intracoastal Health System	271	260	1.04	Includes $36MM capital over 5 years
UHS	Medi-Partenaires (80% stake)	94	75	1.25	EBITDA multiple roughly 6-7x
2000:					
Community	Western AZ Reg'l Med. Ctr.	$66	$50	1.32x	Est'd. 9x EBITDA
Community	Northest Regional Med. Ctr.	81	55	1.47	Estimated 7.8x EBITDA
HMA	St. Joseph Hospital	56	75	0.75	Negative EBITDA
HMA	*Pasco Community Hospital*	*17*	*30*	*0.57*	*Est'd 7x EBITDA of $2-3MM*
HMA	*Davis Medical Center*	*53*	*48*	*1.10*	*No data, margins called "low"*
LifePoint	*Putnam Community Med. Ctr.*	*50*	*50*	*1.00*	*Est'd 6.3x EBITDA*
Province	Bolivar Medical Center	26	32	0.81	Leased from county
Quorum	Caylor-Nickel Medical Center	24	30	0.80	Unprofitable, EBITDA $2-3MM
Triad	*Denton TX/Lewisberg, WV*	*107*	*90*	*1.19*	*Est'd 6.7x EBITDA*
UHS	Ft. Duncan Med. Ctr.	25	29	0.86	$10MM upfront + $25MM rebuild
UHS	*Rancho Springs Med. Ctr.*	*38*	*40*	*0.95*	*Est. 5-6x EBITDA if margin is 15%*

Sources: Company reports, SG Cowen estimates, American Hospital Directory. For-profit transactions italicized

* Acquisition price includes present value of capital commitments

Acquisition Market For Acute Care Hospitals Call Transcript

February 27, 2004, 1:00PM ET

Operator

Welcome to the SG Cowen Weekly Health Care conference call.

During the presentation all participants will be in a listen-only mode. Afterwards we will conduct a question and answer session. At that time, if you have a question, please press the 1 followed by the 4 on your telephone.

As a reminder, this conference is being recorded Friday, February 27, 2004.
I would now like to turn the conference over to Mr. Kemp Dolliver of SG Cowen. Please go ahead, sir.

Moderator

Great. Thank you, Anna.
Good afternoon and thank you for joining us for today's discussion of the acquisition market for acute care hospitals. The topic is important because acquisitions represent a significant portion of the hospital companies' growth rates particularly for the non-urban companies.

The call's format will be a 15 minute presentation by our speaker with the balance of the time available for questions.
Our speaker today is Josh Nemzoff, president of Nemzoff & Company, who has extensive experience with hospital transactions.

For your reference you should have a handout with data on recent acquisition activity including evaluations of acquisitions going back to 2000.

With that I'd like to turn the call over to Josh. Thank you.

Speaker

Thank you, Kemp.

Just a little bit of background for all of you – our company basically buys and sells hospitals. We've been involved in about 150 transactions, total transaction value somewhere over $7-1/2 billion now. I personally have been doing this for about 25 years – buying, selling, and merging hospitals. And virtually all of our clients are not-for-profit hospitals. The only for-profit client we've had in quite some time is a company called Ardent Health, which, as most of you probably know, is backed by Welsh Carson out of New York.

But I've typically been on the sell side of a lot of these, the buy side on some of them, but have dealt with every single one of the for-profits multiple times in terms of buying hospitals. And Kemp has asked me to address today some of the issues relating to what we're seeing in the market, what the opportunities are, what the valuation issues are, and basically how some of these companies perform and what methods they use to buy hospitals.

By way of background, there's an extraordinary number of hospitals that are in trouble. Most of them, of course, are non-profits. And as many of you know, some of the for-profits are in trouble to. But if you look at the S&P and the Moody's and the Fitch down grades and the ratios and some of the available database material, what you'll find is that there are a lot of non-profits both large and small that have gotten into trouble. The reason they've got into trouble is a whole variety of reasons. It's the classic issues of managed care, and malpractice, and information system costs, and labor costs.

But having looked at this market for quite some time our view basically is there's two primary reasons why these hospitals get into trouble. The first and foremost reason, which is completely out of their control, is market share. If they have anything less than 10 to 12% market share, they're operating about a 6 or 8% market share margin, they've probably got a problem. They don't have enough potential in the market to leverage themselves. And you see a direct relationship between hospitals with low market share that get into trouble.

That's not to say you don't see hospitals with large market share. They get into trouble too. But there's usually a pretty good correlation between how much market share they have. So when we're selling hospitals, a lot of times we'll be selling hospitals that don't have a lot of market share, although sometimes we do. Market share is almost totally out of the control of the organization. There's nothing they can do about it. If the market consolidates around them, then that just happens, and they can't do anything.

The larger problem, however, is management. And what we see pervasively, for lack of a better term, is just an astounding lack of management competence in the not-for-profit health care industry. And I say that from the context that the major industry that we represent is, of course, the not-for-profit health care industry. But we have repeatedly told clients that they just have a huge management problem and unless they fix the management problem their hospital's not going to turn around. And they don't fix the management problem, and two years later they call us back and ask us to sell the hospital.

To give you an idea of what the magnitude is of some of these problems, the average EBDIT margin in terms of EBDIT to buy the (unintelligible) net revenue for not-for-profit investment grade hospitals in the United States is about 10-1/2%. There's roughly 400 of these hospitals. They're the top 5% of the non-profit market. And that upper echelon of the non-profits runs at about 10-1/2% EBDIT margin.

Compare that with the average for-profit health care system, which is running somewhere between 18 and 20%, and you start to very quickly see some of the differences. The reasons are pretty obvious. The for-profits have significantly better control over expenses. They're able to control their IT expenses. They're able to control their purchasing costs. You've got HPG, which is a huge purchasing group. You've got the folks out in California doing the purchasing for Tenet. You've got a lot of different purchasing groups that can purchase at significantly better cost than the non-profits can. And even if you look at some of the VHA and the premier purchasing groups, we routinely see HPT and Broadlane beating these prices by 10% or more.

In addition, they're much better at revenue cycle, and they're also significantly better at labor. So what you find is that the for-profits are significantly better at managing a hospital than not-for-profit. And that kind of sets them up fairly well for if they're trying to buy a hospital whether they can buy it and turn it around.

As far as multiples are concerned, what we typically see is that the average for-profit will come in, they'll take a look at a hospital regardless of what its historic performance is, and they'll make an assumption as to what they think they can run it at. Typically depending on how confident they are or how large their ego is they will say we think well we can run it at 15 or 18% multiple. And then they'll typically multiply that times a 5 or 6% margin – 5 or 6 times multiple rather.

If they really want the property, those numbers go out the window. We have seen people look at numbers, and they say even if it's a 20% margin, we'll multiply it times seven. And I'll get to an example of that in a minute.

But typically they're thinking we can probably get this to 15 to 18%, maybe a little higher. They feel pretty comfortable in a 5 to 6% multiple range. They'll certainly go 6-1/2, if they have to. And they're pretty confident that they can get to that range because historically they've been able to. And again this is when a for-profit company is buying a not-for-profit hospital.

If you look at the different options here, you've got for-profits that are buying from non-profits in which case I think there's an excellent chance they can turn the hospital around for all the reasons I just mentioned. The second group is for-profits that are buying from other for-profits. And this is a New American example. It's a NetCare example. It's what happened when Tenet bought OrNda. It's what happened when IASIS bought hospitals from Tenet.

One for-profit buying the cast off of another for-profit in our view is kind of a recipe for disaster. The essential question that we always ask is, if Tenet can't run that hospital, what makes you think you can. The question, of course, that we always get asked is when the for-profits are thinking of selling to a non-profit and the non-profit calls us up and says we'd like to buy Tenet Hospital or an HMA hospital or HCA hospital, that's even worse because we typically tell them your margin's 10-1/2%; theirs is 16%, you know, why on earth would you think of buying this thing. So it's very dangerous in our view for a for-profit to buy a hospital from another for-profit depending on who the operator is.

And as far as non-profits buying from for-profits, that clearly has been a disaster in the past. It hasn't worked in a number of cases, and they're pretty well-known going back to when Columbia sold I believe it was 22 hospitals to five different groups. And every one of those groups was having trouble with it.

From a valuation point of view let me just run you through an example of how we typically look at these, how the for-profits look at it, and how the numbers shake out. And I'll just use a very basic example.

If you have a hospital that has $100 million revenue base and it runs at a 7% EBDIT margin, it's going to have about 7% at $7 million in EBDIT obviously. The question is when a for-profit comes in and looks at it, how it is going to value it. Well they're going to completely ignore the $7 million. Their attitude's going to be we don't care what the non-profit was running; we only care what we're running in that.

They're then going to assume they can get to, for example, 15%. So they're going to assume it's a $15 million EBDIT number. They're going to multiply that $15 million number times five or six. If they really want it, they'll multiply it times seven. And at five or six, that's obviously somewhere between $75-90 million; at seven it's over $100 million. And that's why you see a lot of times, when some of these companies are buying hospitals, they're actually buying them for what we call 100 cents on the dollar, meaning that you've got $100 million in revenue, and they're buying it for $100 million.

When you take a look at the non-profits will typically buy a hospital at half that amount. They'll buy that same hospital for $50-60 million because they're going to assume that they can only run at a 10% margin, so they're going to assume the EBDIT's $10 million, and they're going to multiply that number times five or six times. That's why you almost never see a not-for-profit outbidding a for-profit for a hospital. We have on dozens and dozens of occasions had multiple bidders for a hospital. And we've had non-profit and for-profit bidders. And I'm not sure I can remember the last time a not-for-profit hospital outbid a for-profit.

As far as the range to (unintelligible), probably the best recent example of how far a hospital company will go to buy a hospital system was the Health Midwest transaction not too recently in the past where HCA bought this organization for probably 130 to 140 cents on the dollar. If you work out the numbers on that, even if they got this particular system to a 20% margin, they bought it for probably 6-1/2 times that 20% margin. That system, when they bought it, was probably doing about an 8 or 9% margin. So if they doubled the margin, they would still be at a 6-1/2 times multiple, which depending on how you look at HCA's numbers could be either accretive or dilutive. But clearly it's a premium. But that was probably the best example of what happens when a for-profit really wants to buy a hospital and they pay up for it. It was a competitive bid. And their bid, as you probably know, was literally hundreds of millions of dollars ahead of the next highest bidder.

But in terms of valuation that's how they typically look at it. It has no bearing on what is historically done. Some of these firms are very aggressive in terms of how they bid these things up. Some of them pay prices that our company on the sell side just can't believe. But when you look at the history of it, what you typically find is there's two groups. The one group is for-profits buying other for-profits. And the history of that is not very good. The other group is for-profits buying non-profits. And the history of that in terms of track record, if you look at the HMA's, the Provinces, Tenets, HCAs, the Ardent's, all those companies, is usually extremely good. And the reason is they're very, very good at turning these hospitals around. And as long as they don't pay too outrageous a price, there's a very long track record of these for-profit companies buying a not-for-profit health care system that's got a 6% margin. And you go back a year, a year and a half later and it's got a 16 or 17% margin. And that's why a lot of these companies are doing so well.

So that's kind of a brief discussion of what we see out in the market. And obviously I think there are huge opportunities in terms of these companies buying the facilities. And if they buy the right facilities and if they buy them for the right price, there's a lot of very positive potential there.

Moderator

That's great, Josh. Thanks.

We will start with the Q&A. And what I'll do is ask the first question while, Anna, once I ask the first question – and if you could go ahead and review the queuing procedure, I'll ask the first question, and then we will take questions from the audience.

Operator

Thank you. Ladies and gentlemen, if you would like to register a question, please press the 1 followed by the 4 on your telephone. You will hear a three-tone prompt to acknowledge your request. If your question has been answered and you would like to withdraw your registration, please press the 1 followed by the 3. If you're using a speakerphone, please lift your handset before entering your request – one moment please for the first question.

Moderator

And while we're waiting for that first question, Josh, one thing that we see is a transaction price put on the table much the way you would have with HCA/Health Midwest that will also involve future capital commitments over a period of time. Could you talk about how those are actually valued? Some of the companies will dispute whether they're actually giving something of value to the seller.

Speaker

Well that's a very interesting question. What they pay and what the seller gets are two different numbers.

Our view of it is that, if you're the buyer and you have to buy a hospital for $100 million and then put $50 million into it that hospital costs you $150 million. Whether the seller got the other $50 million or not is irrelevant when it comes on to your financial statements and you've got to account for it, it costs you $150 million. So in the Health Midwest situation where they put in a guarantee of I think it was close to $400 million, if I recall, from a valuation point of view any amount that's paid to the seller, any debt that's assumed from the seller plus any capital committed, whether it's to the seller or not, all three of those go into the total cost. And the total cost for the Health Midwest transaction, at least the way we would account for it, clearly would assume any capital.

The most glaring example of these is Province and a couple of others have done transactions – I think Community has too – where they will really buy a hospital based on a promise to go build a $60 million replacement facility. And you could make the argument that the purchase price wasn't $60 million, and you could make the argument that it didn't cost us $60 million to buy the hospital, but the bottom line is you just put $60 million into that hospital and that's your cost. And it doesn't really matter who it went to. When you have to get a return on investment, that's going to be your investment. So we always include capital in terms of the assessment of what the cost is.

Moderator

Great. Do we have any questions in the queue, Anna?

Operator

Yes, we do. Can we go ahead and proceed with the first question

Moderator

Yes.

Operator

Thank you. Please proceed with your question.

Question Hi. You had mentioned that the for-profits are much better managed than the non-profits. And I was wondering if you could give some specifics on where the non-profits are really dropping the ball? Which areas are the ones where they need the most improvement?

Speaker What I was saying is that, you know, clearly the for-profits manage to much better numbers than the not-for-profits. One or two examples would be from a labor point of view the average labor for a for-profit entity is between 38 and 41% of net revenue. So if you looked at all their salaries plus their benefits, typically it's about 40% or so of their net revenue. The average not-for-profit is closer to 50%. That is a huge difference in terms of bottom line performance.

Another example, as I mentioned, is the purchasing group. You know, we have routinely seen these big purchasing companies for the for-profits, Broadlane, HPG, and others, come in and immediate drop their supply expense by 10%. And again all those things go right to the bottom line.

Operator Thank you. Ladies and gentlemen, once again, if anyone would like to register for a question, please press the 1 followed by the 4 on your touchtone phone.

We now have another question. Please go ahead.

Question Yeah hi, just a question regarding the acquisitions and what the acquiring hospital or hospital company looks at. How important is population growth, maybe the mix of payer? And what really weights – how do those factors weight in regards to paying either five times, or six and a half, or seven times? Can you just flush that out a little bit more?

Speaker Sure. You know clearly what the buyer's looking for is can I get to an 18 or 20% margin. There's lots of ways of doing that. But if you subscribe to, as hopefully all of you do, the classic paradigm in health care, and that is, if you have market share, you're probably going to have volume; and if you have volume, you're going to have revenue; and if you can control your expenses, you should be able to have a decent bottom line – so it's all start with market share and volume. Therefore, they're going to look at the market and make sure that the population is growing and/or they're going to look for the market where they think they can increase their market share by identifying other available hospitals that they could purchase, again the concept being the volume.

As far as payer mix, you know, that certainly is part of it too. You know, they don't want to be in markets where the payer mix is terrible. And that's why you see very few of these for-profit health care companies going into large urban markets. Tenet going into Philadelphia was one example. Tenet obviously is getting out of California and a number of the markets. But the payer mix in a lot of the areas where the for-profits own hospitals is significantly more favorable than it is in other parts of the country. You don't typically see for-profits buying facilities in Boston, New York, Detroit. Some have done it in Chicago, and a lot of have regretted it – Los Angeles the same type thing. So they look at all those factors in terms of non-expense type factors. But they're really going towards a goal of can I get to an 18 or 20% margin. And as I say, one of the biggest factors that we typically see is that their feeling is, if an organization has 22, or 23, or 25% market share, regardless of what's going on, they think they have a much better chance of getting to a higher margin than a facility that has 7 or 8% market share.

Question

Okay. And then is there a market share where they can't penetrate above, as in where the FTC gets concerned? Is that something we should kind of be conscious of?

Speaker

The threshold that people talk about, although it's certainly been pierced a number of times, is somewhere in the 40% range. Once you get north of 40% -- I mean there is a specific index the government uses – but once you get north of 40% you are potentially putting yourself in line for a second request from the Federal Trade Commission. That doesn't mean you're going to lose, but it certainly means that there could be an issue there.

I can tell you from the sell side, if we're selling a not-for-profit hospital and there's five or six bidders and one of them is an in-market bidder, unless their bid is outrageously higher than the other bids, if that in-market bidder is going to take it, for example, to a 45 or 47% market share and the out of market bidders, of course, aren't going to affect that at all, we almost always will gravitate to an out of market bidder because we don't want to sell a hospital to somebody and get a call from the FTC the next day saying it's under review, but if you had to pick a threshold, probably about 40%.

There have, of course, been cases where people have gotten higher than that. There's some outrageous cases where people have really gotten high like that out in Salt Lake City in Intermountain Health Care. And of course there's places where they've got two hospital towns that have consolidated to one hospital, which obviously by definition is a lot higher than 40%. But 40% is pretty much the number that we use and other people use to say that's the first warning sign that there might be a problem, not that there is.

Question

Thanks.

Operator

Thank you. Next question. Please proceed with your question.

Question

(Unintelligible) Tenet's asset sales may be going, if you're heard any color on that? And then also just more broadly speaking – you said there's a number of not-for-profit hospitals that are doing poorly – are you seeing, you know, more inventory for sale or just generally what your kind of expectations are for that and if multiples are kind of heading one way or the other?

Speaker

Okay. As far as Tenet's concerned, I mean, Tenet obviously is in round three of selling off hospitals. They sold I think about 15 of them roughly four years ago. Those were hospitals that were under performing assets. They sold another 14 or 15 of them this last year, again hospitals they thought were somewhat under performing assets. And now they're going with I believe it's 27 hospitals. Again some of those are non-performing assets.

But a lot of the hospitals they were selling by not-for-profit standards, you know, were actually doing reasonably well. By for-profit standards they weren't. So it seems that the strategy Tenet is using other than obviously exiting a lot of markets in California is to kind of clean up its house a little bit and get rid of some of these facilities. There also seems to be an extraordinarily large proportion of hospitals that were OrNda hospitals that they took over, the ones in Massachusetts certainly were, and there's some other ones. But they just seemed to be continuing to cull the heard until they have the finest livestock they can left. And when they get down to their 65 or 69 hospitals, almost all those hospitals should be very well performing facilities.

As far as the non-profits and what we're seeing, we track to a variety of databases a huge amount of information on financial ratios for hospitals. What we're looking at is days cash on hand, EBDIT margin, and debt service coverage. EBDIT margin is pretty easy to track in a non-profit because EBDIT in non-profit parlance is the exact same number as income available for debt service. But we have certain parameters set up where we're basically tracking hospitals that fall through the floor, for example, their days in cash drops below 60, their coverage drops below 2, or their EBDIT margin drops below 7. And in the last two years the number that have fallen into those buckets has increased dramatically. So we're just seeing more and more hospitals that have gotten into financial trouble.

The interesting issue that you raised is just because a not-for-profit hospital is in trouble doesn't mean it's going to sell. You know, the joke in our industry is that non-profits don't sell when you put a gun to their head; they only sell when you pull the trigger. And they really have to be in trouble before they sell. You know, we see dozens and dozens of hospitals where you look at them and you say, you guys have a really big problem. You're losing market share. Your EBDIT's down. You're running out of cash. And we don't think you're going to survive for more than a year. And they will look you right in the eye and say don't worry. We can fix this, and our CEO has a plan. And then a year or two later you read about them being sold. But just because a non-profit's in trouble doesn't mean it's going to sell. And, of course, the for-profits, as you know, spend an inordinate amount of time out there in the wilderness trying to convince these not-for-profit hospitals that they really need to sell.

Question

Yeah. So generally speaking you think that – are you saying that Tenet should be successful in its endeavors to sell properties? I mean have you looked them in specific or...?

Speaker

Well they're only going to be successful to the extent they could find good buyers. They have been able to do that. And Tenet, as all of you know – and we, by the way, have no relationship with Tenet and have never represented Tenet. We've sold hospitals to them a couple times. But Tenet has just had an unbelievable strain of bad press and bad luck over the last 12 to 15 months.

We encountered it because we got hired to sell a hospital in Slidell, Louisiana, and the winning bidder was, in fact, Tenet. And that was right when all this stuff was starting up about (Austell) and Redding and Poplar Bluff, and the outlier stuff. And it was, you know, every week you'd wake up with a new press release causing problems. But Tenet just had a lot of trouble. And if I'm a buyer and I'm thinking of buying one of those hospitals, I need to ask myself the question of am I going to be able to run it better than Tenet has and is there something wrong with this hospital.

I think they should be able to find buyers. I've dealt with them on the buy side when they've been selling hospital. We represented people that were trying to buy hospitals from them. I've sold hospitals to them. And for all the problems Tenet's had they're a very competent and very sophisticated bunch. But they just seem to be selling a lot of hospitals in a short period of time. I think for most of them they should be okay.

Question Great. Okay. Thank you very much.

Speaker Thank you.

Operator Thank you. Next question. Please proceed with your question.

Question Hi. I was curious if you could talk to the competitive environment for smaller unprofitable hospitals, something in the $25 to $35 million revenue range that's currently not making money but could be turned around?

Speaker Well what you've just stated is in our view an oxymoron because you've got $25 to $35 million of revenue. That means you probably are the size that is economically disadvantageous to surviving.

I'm not aware of any – there may be some – but I'm not aware of any hospital that has 100 beds or less that has investment grade rating in the United States. And the general rule of thumb that we've seen is that once you get below a census of roughly 50 patients the fixed cost you have just become so large as a percentage of your business that it becomes very difficult to make a lot of money. If you get down to the $25 to $35 million range, which obviously is a hospital with, you know, probably 25, 30, maybe 35 patients in it, that's a very, very small hospital. And there's a very, very narrow band in terms of being able to buy one of those and operate it.

We have clients right now that we're representing that are selling two or three hospitals just like that because it's been made very clear to them that it's just not going to survive. So when I see LifePoint our there, and Province out there, and Community Health, they usually – they have done it in the past, but usually they're not trying to buy hospitals that are at $25-35 million. And when we do, we sort of ask the question of, you know, why would you do that?

The companies that did buy a bunch of those small hospitals, like NetCare and (New American), did not fare very well with them. So my view is that you really shouldn't be thinking about buying anything that has less than $40-50 million in revenue because you may not be able to make it work even if you are a good operator that runs a for-profit system.

Moderator Josh, if I could follow up on that point, with the rural companies there seems to be an emphasis post acquisition of building the outpatient offering and moving the mix that way. Does that – do you think that's viable? And do you think that mitigates some of the risk you're highlighting?

Speaker

If they've got a hospital in the area and they're buying a $25 to $30 million hospital for the purpose of turning it into an outpatient facility and using it as a feeder to another facility, that's a completely different model. And that was the question. That is a pretty good model. And that does make some sense. But keeping it open as a full service acute care hospital is just not economical. But, you know, we do see that a lot where they'll buy a much smaller hospital and try and close it down as an inpatient facility. Sometimes they try and close it down completely.

But again it's all a market share game. And the more market share they can get and the more volume they can get the better off they are.

Operator

Thank you. Next question. Please proceed with your question. Your line is now open. We are not hearing you. Please check your mute button.

Question

Pardon me. Can you hear me now?

Speaker

Yes.

Question

Sorry. Actually my question was partially answered in the case of somebody else asked about Tenet. I guess the question mark in the marketplace as to what kind of value they can realize on these units – and you'd already indicated earlier in the call that one should be skeptical about looking at buying a hospital from another for-profit company, if you are also a for-profit company. I just wanted to get a sense of what kind of realizations of pricing they might receive and is the marketplace perhaps expecting too much of too little out of these sales?

Speaker

That's a very good question. They're not selling hospitals that have 20% and 22% EBDIT margins. And based on the last two rounds they've had they probably aren't selling too many that have a 7% or 8% margin. What they typically I assume would be selling – we've only seen a few of them – are hospitals that are probably in the 12% to 15% range in terms of EBDIT. And they probably think that they're not going to be able to sustain those levels. So as far as another for-profit buying them, you know, I would probably stick to my earlier comment that, you know, if a for-profit buys those hospitals for a multiple of 6 or 6-1/2 times what Tenet's running it at, you're right back to the model I was describing that is what makes you think you can run it better than Tenet can.

If an in-market provider buys it, whether it's for-profit or not-for-profit and there's some consolidation opportunities, obviously the economics become very different. And that's an area that I didn't mention before. But, you know, clearly, if you own a hospital in a service area and there's an opportunity to buy another one, all the multiples I mentioned just go completely out the door. You can afford to pay significantly more than those multiples, if you're planning on consolidating. So, you know, if HCA or HMA owns another hospital near one of those Tenet facilities or up in Massachusetts if one of those big not-for-profits decides to buy one of the Tenet facilities, they might be able to pay significantly more.

But, you know, you're having a bit of a fire sale. You've got a company that clearly is in a little bit of trouble. And they just got done announcing they were planning on selling 14 hospitals a year ago because they made a strategic decision that those were the only ones they needed to get rid of. Now they're back about a year later saying well there's actually another 27. And those 27 facilities are obviously hospitals that they have now decided they want to dispose of also. They're probably in much better shape than the 14 they had last year. If they weren't, they would have sold them last year too.

So I would assume that they should do okay with them. I don't think they're going to get premium pricing for any of these, but I think they should do reasonably well. And I don't think they're going to give them away. If somebody offers them three times EBDIT, they probably just want to sell them.

Question

I guess related to that just in general what do you see is the trend in pricing right now compared to say what we might have seen a year or two ago? And is there a lot of their merchandise available in terms of the not-for-profits that could be purchased by the for-profits?

Speaker

Pricing wise, you know, I have not seen pricing change – and I've been doing this for a long time – but I have not seen pricing change very much at all in the last three or four years. What happened was from probably 1993 or 4 till 1997 when Columbia was in the market and they were aggressively buying, you know, from my point of view, as somebody who primarily sells not-for-profit hospitals, it was like Christmas every day because no matter what you were trying to sell there were five buyers, and they were just paying ridiculous prices. And they were all in competition for the Columbia facilities.

And one glaring example is we got hired by JFK Medical Center in Atlantis, Florida near West Palm Beach to sell them, and we ended up selling them to Columbia. And I remember the first meeting I said, well, you know – they said, we need to sell because we're having financial problems. And they showed me their financial statements. And I said I don't know what numbers you're looking at, but you're doing just fine. Why do you need to sell? And they said well actually we'd like to have a big foundation. We sold that hospital for $275 million. So up until '97 these things were selling for just huge multiples, and we'd just kind of sit there and hold our breath at the closing hoping the wire transfer would come through.

And then for two years everything shut down, as you know – shut down for a couple of reasons. The first reason was that Columbia obviously had some issues. And the second reason was the Alleghany Health System in Philadelphia went down the tubes and then took the capital markets with it. So the Columbia issue kind of soured the for-profit industry on buying some hospitals. And when Alleghany went down the tubes, it took all of the buying power of a lot of the non-profits out of the market. So there was a period for two or three years there where you really couldn't sell hospitals for those types of multiples.

That all ended, you know, about two or three years, probably three years, ago. And in the last three years, you know, it's kind of back to the pre-Columbia days. And I didn't mean that from a South American point of view but the pre-Columbia hospital point of view. And people are paying five and a half to six times what they think the margin is going to be. And they're doing it pretty consistently.

What we have seen is we've seen some of the newer companies, the Provinces, the ESSENT, others, that sometimes will pay up higher than that. And we've also seen, you know, other companies like Vanguard and Ardent that are getting very good deals by buying actually at lower multiples and have been doing very well in terms of doing that.

But the basic concept or the basic mathematics of what makes sense is that, if you have a hospital with $100 million in revenue, and you think you can do $20 million a year, and you buy it for five times EBDIT, which is 100 million bucks, you have a 20% return on investment. If it turns out that you can't do $20 million a year and you just spent $100 million for it, you've got a 10% return on investment. Those mathematics or those economics haven't changed, you know, for 10 or 20 years. It's just a function of how badly they want it. And, you know, some of the things we've seen that people have competed for are just incredible in what they're paying and others there's not been a huge market, and you don't get those types of multiples.

Question In terms of…

Moderator I'll follow up on that – oh go ahead.

Question I was just – the other part of this was merchandise available. I gathered that there's still plenty of good merchandise available then. Is that correct?

Speaker From what we're seeing there is an unbelievable number of hospitals that are in trouble that should be sold. And if a for-profit were to buy any of those hospitals, they would probably do extremely well because the reason those hospitals are in trouble is because their either management is terrible or there's some other things going on that are easily correctable. But I think, if you look at the universe of hospitals out there in the United States for for-profits to buy, if they could buy some of these hospitals, there are tons of them out there that they should be able to turn around. And we just see it over and over again.

Question Given that, it sounds like we should be buying into your business.

Speaker Probably. We're certainly not suffering for clients.

Question Good. Glad to hear that. Thank you.

Moderator If I can follow-up briefly before the next question, is there anything other than market share that we can look at that would help determine what the potential margin of a hospital would be – and I'm thinking of maybe measures such as case mix index, or payer mix, et cetera – any other good rules of thumb in terms of outside indicators?

Speaker Well one is market share, of course. The other is, if you get a copy of the financial statements of whatever hospital they're thinking of buying and if you have their P&L, the line that I always go to is I look at salaries plus fringe benefits, and I divide that by net revenue. And if that number is in the 50% or more range, then there's a huge opportunity because you know these for-profits are going to get it down to somewhere in the high 30s or low 40s. And it's going to take them six months to a year to do it. But it's not uncommon. We've looked at hospitals where the labor percentage is, you know, 60%, 61%, 62%. And they go in there and they start cutting staff immediately.

Let me give you the most glaring example. And it's not an acquisition, but you'll get the drift. About four years ago, maybe five years ago – I can't remember my dates – the University of Pennsylvania Health System, which is a huge health system, was losing close to $200 million a year. The president of the university was thinking of selling the health system. The president of the hospital, a gentleman named Dr. Kelly, was saying you can't tell me what to do, I'm the president of the hospital. And the president of the university said you must be confused. This is our hospital. You're fired. And they threw him out.

And they brought in this company out of Florida called The Hunter Group, which I'm sure you've all heard of. And in the space of less than nine months The Hunter Group fired 2800 FTEs. They fired 20% of the workforce of the University of Pennsylvania Health System. They didn't close any services. They didn't close any facilities. They didn't close any programs. Nobody complained about any quality adjustments. They simply wiped out 20% of the labor force. And at an average FTE cost of $60,000 to $62,000 times 2800 FTEs, most of their $200 million problem went away.

The reason we use that example repeatedly is how many corporations in this country do you think there are that could wipe out 20% of their workforce, not change their service deliveries at all, and keep function. That should give you a clear indication of how overstaffed some of these non-profits can be. And Penn was just one of the most glaring examples. But there's plenty of others just like it.

So we tend to focus in immediately on the labor costs and see where that's really out of whack. And, of course, you do see some that are in the 43%, 44% range. And you look at those and say, well maybe there's not that much of an opportunity in it. They're at an 8% EBDIT margin, but their labor's at 44%. They may be doing a reasonably good job at controlling their expenses. But you talk with any for-profit operator in the United States and what they'll tell you is that they will get those labor costs in line, and they'll get them in line very, very quickly. And it becomes very easy to look at a P&L and figure out where there's an opportunity to do that.

Moderator

That's great. Thanks. Next question?

Operator

Thank you. Next question. Please proceed with your question.

Question

Yeah. My question has to do with kind of the specialty guys. I mean is there any difference in the multiples either for the rehab guys or for the psych guys at all in terms of what people are willing to pay or how you look at them maybe differently?

Speaker

There's definitely a difference. And depending on what year you're buying them, they're much higher risk acquisitions because they have a much more homogenous line of service, whether it's rehab, or psych, or the cardiac hospitals, and the ortho hospitals. You know, some of them are very, very dependent on reimbursement, for example, psych and rehab. Others are extremely dependent on referral patterns like the ortho hospitals and, of course, the cardiac hospitals. But they also some of them can be very profitable.

But we typically don't see those multiples as being quite as high because the risk is a little bit greater. If the federal government, for example, changes the reimbursement methodology for psychiatric hospitals, which they did a while back, it can crater the entire industry. We've seen the federal government change the reimbursement methodology for nursing homes, for example. And all of you I guess are health care analysts. I don't need to tell you what happened to the nursing home industry when they changed the Medicaid regulations. But those are very susceptible to changes like that. And because they have really only one or two lines of business they're much higher risk. So you don't typically see somebody paying those types of numbers. You also don't see the margins. Most people don't go out and buy a psych or rehab hospital thinking they can get it to 20%. They assume it's going to be something lower than that.

Question

Okay thanks.

Operator

Thank you. Next question. Please proceed with your question.

Question

Hi. In California when you throw the nurse staffing rules on top of earthquake costs is that going to – what's that going to do to the market out there? I mean are the hospitals going to have to raise prices, or are all the margins just going to be lower? What are you seeing particularly as it relates to the staffing in California?

Speaker

The margins are all going to drop. I don't think it's a coincidence that Tenet's thinking of selling – what is it – 19 hospitals in California and they're dealing some of the outlier issues and the margin issues. But, you know, as far as those staffing regulations, if they're forced into it, which they are going to be, that clearly is going to limit the ability of some of the for-profits to run at those numbers, and it's going to impact their margins. And of course all their staffing problems are not relating to nursing, but certainly some of their staffing issues that are very expensive are relating to nursing because they have to staff at those levels, and they can't get the nurses. Now they're into overtime and agencies. And agencies is going to be at least twice, if not two and a half times their cost. So whereas a regular nurse might cost them $50,000 on regular staffing, if they have to put an agency nurse, it could cost them $100,000 or more. So it could be a compounding effect that not only do they have to have the staff there but now they've got to go out and get a per diem to do it.

Question

Do you have any sense as to what kind of – you know, you mentioned not-for-profit being a 50% labor cost and a for-profit can perhaps quickly drop that to 40.

Speaker

Right.

Question

What does that mean in percentage terms? Does that mean now you can only go from 50 to 45 or 50's as good as it gets so the not-for-profits won't find buyers, or, you know, any numbers you can put around that?

Speaker

You mean relative to the California nursing issue?

Question

Yeah, yeah, is that a 5 percentage point kind of cost, you know, a 3 percentage point, 8 percentage point, any ideas?

Speaker Well you've got to assume that nursing costs are probably at least 30% to 40% of your overall costs, so if that gap – just to make it easy – if the gap is between 50% and 40% and all of a sudden somebody takes away your ability to close that gap for nurses, then you're not going to be able to get from 50 down to 40. You're only going to be able to get from 50 down to 43 or 44.

Question Okay. Okay great. Thank you

Speaker Sure.

Operator Thank you. Ladies and gentlemen, as a reminder, to register for a question press 1 followed by the 4 on your telephone. Our next question. Please proceed with your question.

Question Yes. Could you tell us – I've been on and off the call – but could you tell us what's happening with the HealthSouth facilities?

Speaker That's a good question – any specifically or just in general?

Question In general.

Speaker Well much to our surprise HealthSouth seems to be righting itself fairly quickly. I'm not sure exactly how they've done it, but they seem to be doing it. They, as you know, did get rid of one of their acute care hospitals in South Florida I believe. They've got another one in Birmingham. But so far I have not heard anything about, you know, what they're planning on doing with those facilities and restructuring there. They seem to be turning the corner a little bit in terms of some of their PR issues and some of the number issues. But I've not heard anything relating to them putting blocks of those facilities up for sale or changing the way they conduct their business.

Question Thank you.

Operator Thank you. Next. Please proceed with your question.

Question Thanks for taking my question. I was wondering – you are pretty critical of for-profit hospitals buying for-profit from for-profit hospitals. In the case of Tenet, is that a special situation where they're, you know, maybe going to have a liquidity problem, and they're trying to sell assets quickly so that's maybe a little different than the normal, you know, for-profit/for-profit transaction?

Speaker Well I mean Tenet may be selling some of these hospitals to raise capital, and they certainly will raise capital doing it, which would help their liquidity. But, you know, from our point of view my criticism of for-profits buying facilities from other for-profits doesn't relate, of course, to the seller, it relates to the buyer. And we just – a better way of putting it is Tenet's going to have a reason for getting rid of these hospitals, as is any for-profit seller. And the history has been for years, and years, and years out of Nashville and Naples, Florida, and Santa Barbara, California, where all these for-profits are that, when the for-profits sell a hospital, it's one that they simply don't want because they can't make it work. And the question I always ask – and I ask it, of course, of my clients who are typically non-profits thinking of buying it, and I'm much more critical, of course, of a non-profit buying a for-profit than even a for-profit buying a for-profit – but my question is always the same, and that is, if Tenet can't run it – it's not like Tenet's a bunch of idiots. Tenet's a very capable firm. They've got a lot of very bright people. And up until the last 14 or 15 months, you

know, probably most of the people on this call considered them to be very capable operators. But they know what they're doing, and they're very good at running hospitals. So the question always becomes, if they can't run it, what makes you think you can. And that's the concern I have when one for-profit buys another.

Now I don't really care because the for-profits aren't my clients; the non-profits are. But when you see the facilities NetCare picked up, when you see the facilities that New American picked up – when IASIS bought the hospitals – they were part of the first round of Tenet operations I think four years ago – they bought a number of the Tenet hospitals. That's I think basically how IASIS was started. And it's taken them four of five years go get on their feet from buying those hospitals. So it's just kind of the old joke, you know, if you want to buy Jeff Gordon's race car because you think you can drive it faster than he can, you know, go ahead. But, you know, it's the exact inverse of a for-profit buying a hospital from a not-for-profit where the for-profit can look at the history and say I think I've got a pretty good, you know, shot at running this thing a lot better than they can because I know how non-profits run. If I'm a for-profit buying one from Tenet, I should be asking myself the question do I really think I can run it better than Tenet can. And I can't answer that question for them. But, you know, you could probably guess what my thought would be.

Operator

Thank you. Ladies and gentlemen, as a reminder, to register a question you may press 1 followed by the 4 on your telephone.

There are no further questions at this time. I will turn the call back to you. Please continue with your presentation or your closing remarks.

Moderator

Great. Thanks. Actually I will throw in a question or two here.

Josh, do you observe any significant differences between the various for-profit companies in terms of their due diligence approach, style when they present themselves to sellers, you know, any nuances that make any material difference?

Speaker

Well they all sort of focus – I mean, all the deals they do are typically asset deals. But they all focus on identifying the expense issues. They focus on some of the opportunities for getting expenses down. They certainly look at the market. They look at the medical staff. The due diligence procedures that you typically see at for-profit – and our clients have been on the receiving end of that literally 100 times or more – is very, very similar.

Some of them have certain areas they focus on more. Some like to focus more on the physicians. Some like to focus more on the labor expenses. Some of them are very careful, for example, about environmental issues. Some of them, you know, could care less about environmental issues. But what they typically do – and virtually all of them do this – is they basically put the hospital into their mold. And by that I mean they take a look at the hospital and they say this thing's running at a labor rate of 48% of net revenue.

We run it at 41%. This hospital's supply costs are X. We know we can save 8%. You know, they're having IT costs equal to some number, and we think we can run it. And they basically try and take a look at that hospital and say, if we were running that hospital the way we run our other hospitals, what would those numbers be. And that's how they get to the 15% or 18% projection in terms of the numbers. And they can usually do that very, very quickly.

Then what they do is they go out and try and confirm that those numbers are correct. And then most of them are very good, especially their legal teams, at looking at the high risk areas and those things that are going to, you know, really kind of nail them to the wall. And they protect themselves very well, you know, from those types of risks. And those are typically, you know, the malpractice risks, which they make sure the seller keeps. They're the cost reports to make sure there are not many open cost report liabilities. They're the environmental issues, which can be a huge issue. And they're also some of the physician contracting issues to make sure they're not getting contracts that are either illegal or onerous. But, you know, my experience having been on the receiving end of, you know, many, many for-profits conducting due diligence on hospitals who are selling for literally all of the for-profit companies is they're all very, very good at doing their homework and analyzing the situation.

Moderator That's great. Any other questions from the audience?

Operator There are no questions at this time.

Moderator All right. That's great. Again I'd like to thank everybody for joining us this afternoon. I'd also like to thank Josh for taking time out of his schedule to participate in today's call. Have a good day, and we will see you soon.

Operator Ladies and gentlemen, that does conclude the conference call for today. We thank you for your participation, and we ask that you please disconnect your line.

END

Joshua A. Nemzoff Biography

Mr. Nemzoff's primary area of expertise is the development and implementation of acquisition, divestiture and merger plans for hospitals and hospital systems. He has served as the project director and lead negotiator for more than $7 billion of health care merger and acquisition transactions.

Founded in 1994, Nemzoff & Company is the leading provider of merger and acquisition services to acute care hospitals in the United States. Mr. Nemzoff has been involved with more than 175 merger & acquisition engagements, and is nationally known as one of the leading hospital merger and acquisition experts in the country.

Prior to forming Nemzoff & Company he was a partner with Ponder & Co., and was in charge of the merger and acquisition division. Ponder & Co. is the leading financial advisory firm to non-profit hospitals in the United States.

Mr. Nemzoff was the director of acquisitions for HealthTrust, Inc. (HTI) in Nashville, Tennessee before joining Ponder & Co., where he was in charge of buying and selling hospitals for the company, which was the second largest for-profit hospital system in the country. While at HTI, Mr. Nemzoff was the project director and lead negotiator for numerous merger & acquisition transactions.

Before joining HTI, Mr. Nemzoff was the regional director for health care mergers and acquisitions for Ernst & Young's Southeast Region. Based in Miami, he was in charge of a significant number of acquisitions and divestitures throughout the region.

Mr. Nemzoff has a BA from the University of Pennsylvania, an MBA from New York University and an MPH from Columbia University.

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