

May 3, 2012

Dear Investor:

Enclosed are Inova Health System's Obligated Group unaudited financial statements for the first quarter of 2012. All information is presented on a year-to-date basis.

We appreciate your interest in Inova Health System. If we can provide any other information, please let me know.

Sincerely,

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Attachments

**Inova Health System Obligated Group
Management Discussion and Analysis
For the Three Months Ended March 31, 2012**

Introduction

Inova Health System (the System) is a not-for-profit health care system serving Northern Virginia, Washington, D.C. and parts of Maryland, offering a comprehensive array of services at multiple access points. The System includes five hospitals with over 1,700 acute care beds, and other health services such as emergency and urgent care centers, senior services, home care, mental health and blood donor services. Services range from health promotion/disease prevention to the most advanced services with specialty distinction in a number of areas, such as cardiology, neurosciences, orthopedics, women's and children's services and cancer care. The System's mission is to provide quality care and improve the health of the diverse communities it serves.

The following discussion and analysis of operations and financial condition provides information that management believes is relevant to an assessment and understanding of the Inova Health System Obligated Group's results of operations and financial condition. This discussion should be read in conjunction with the Obligated Group financial statements for the three months ended March 31, 2012.

Three Months Ended March 31, 2012

Results of Operations

Total operating revenues for the period were \$552.9 million, up 1.8% over 2011 primarily due to 1.6% growth in admissions and observation cases, and 5.32% growth in emergency department visits.

In July 2011, the FASB issued 2011-7, "*Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*." ASU 2011-7 requires healthcare organizations to present their provision for doubtful accounts related to patient service revenue as a deduction from revenue, similar to contractual discounts. In addition, all healthcare organizations will be required to provide certain disclosures designed to help users understand how contractual discounts and bad debts affect recorded revenue in both interim and annual financial statements. For nonpublic entities, the amendments are effective for the first annual period ending after December 15, 2012, with early adoption permitted. Management elected to reclassify bad debts as a deduction from operating revenues beginning in 2012, and restated 2011 to conform to the new presentation.

Total operating expenses for the three months ended March 31, 2012 increased by \$6.0 million or 1.2% over the prior year. Overall salary and benefit expenses decreased 3.0% from the prior year primarily due to outsourcing of certain support services and a general improvement in productivity. These outsourced service costs are now reported under "Other Operating Expenses", which has increased approximately 8.7% versus prior period. In addition to the outsourcing initiatives, Inova has implemented a new information technology

strategy that includes an enhanced research informatics database; upgrades to existing information technology applications and preparation for the mandated conversion to the International Statistical Classification of Diseases Version 10 (ICD-10) coding and billing protocol; and implementation of the Epic Systems Corporation's clinical and revenue cycle applications, including their electronic health record (Epic). Significantly all costs associated with design and implementation of Epic will be capitalized. Ongoing operational costs, including end-user training and post-implementation costs will be expensed as incurred. We anticipate the implementation of the Epic system will result in increased spending through the fourth quarter of 2013. Operating expenses were also impacted by acceleration of amortization and other costs associated with applications to be replaced by Epic.

Operating income for the Obligated Group was \$61.4 million or 11.1% of total operating revenues while the operating cash flow margin was 18.4%. The annualized debt service coverage was 7.7x for the three months ended March 31, 2012.

Investment Performance and Other Non-operating Activity

The following table summarizes the asset allocation for the Plant Replacement and Expansion Fund as of March 31, 2012 (dollars in thousands):

<u>ASSET CLASS</u>	<u>AMOUNT (000's)</u>	
Strategic Fund		
Cash and cash equivalent	93,856	3.4%
Global bonds	211,675	7.6%
Core bonds	315,669	11.3%
Domestic equity	215,515	7.7%
Global equity	601,780	21.5%
Strategic	264,729	9.5%
Opportunistic	94,901	3.4%
Inflation sensitive	463,001	16.6%
	2,261,126	81.0%
Capital Fund		
	529,262	19.0%
	529,262	19.0%
	2,790,388	100.0%

Fixed income instruments can be domestic or global, and are typically investment quality with maturities ranging from one year to 30 years. Equity investments are typically exchange traded stocks. Alternatives can include private debt, hedge fund of funds, and private real estate funds.

A portion of the fixed income assets was segregated into a limited maturity, high quality portfolio (Capital Fund). This fund was established to ensure that the Obligated Group would have sufficient liquidity to move forward on critical construction projects in the event of a major financial market disruption.

The following table shows the components of the *Investment income and other, net* line from the Consolidated Statements of Operations for the three months ended March 31, 2012 and 2011 along with unrealized gains (losses) on investments and interest rate swaps (dollars in thousands):

Description	2012	2011
Interest and other income, net	\$ 12,143	\$ 7,176
Gains (losses) in fair market value of interest rate swaps	6,652	3,319
Realized gains	32,819	48,901
Other than temporary declines in fair market value of investments	(2,441)	(2,988)
Other	5,192	3,988
Investment income and other, net	54,365	60,396
Unrealized gains (losses) on investments, net	99,113	13,693
Change in fair value of interest rate swaps	2,972	2,806
Total investment and swap related activity	\$ 156,450	\$ 76,895

The Obligated Group's unrestricted cash and investments at March 31, 2012 were \$3.1 billion, of which only \$700 million represented investments that cannot be liquidated within 3 days. In addition to its unrestricted cash position at March 31, 2012, the Obligated Group had \$64.7 million of Series 2010A bond proceeds available for new construction projects.

Capital expenditures were \$56.2 million for the three months ended March 31, 2012. The Obligated Group spent \$38.1 million on major projects (including \$21.6 million related to the Inova Fairfax Hospital 2015 project, for which site work and construction began in Q3 2010) and \$16.6 million on acute care equipment, renovations and replacement.

Unrestricted net assets grew by \$219.8 million or 7.4% from December 31, 2011.

Debt Structure and Liability Management

At March 31, 2012, the fair value of Inova's aggregate interest rate swaps was a liability of \$64 million. There were no collateral posting requirements with any counterparty.

At March 31, 2012, total long-term debt outstanding was \$979 million, or 23.6% of capitalization. The Obligated Group also maintains unsecured lines of credit with two large commercial banks at a combined amount of \$87.5 million. There were no amounts outstanding on these credit lines as of March 31, 2012.

Pension and Other Postretirement Benefits Accounting Change

During the second quarter of 2011, Inova changed its method of accounting for its pension and other postretirement benefit plans, including the IHS Retirement Income Plan (the "IHS Plan") and the IHS Retiree Medical Plan (the "Retiree Health Plan," and together with the IHS Plan, the "Plans"). The accounting method changes include: a) changes in the method of calculating the market-related value of plan assets (applicable only to the IHS Plan as the

Retiree Health Plan is an unfunded plan), b) changes in the method of accounting for actuarial gains and losses and c) changes in the recognition of certain recurring settlements. These changes are intended to improve the transparency of Inova's operational performance by accelerating the recognition of gains and losses in the net periodic benefit cost. Please refer to Note 2 of the Audited Consolidated Financial Statements for a detailed description of the plan changes.

These changes have been reported through retrospective application of the new method to all periods presented. The impacts of all adjustments made to the financial statements are summarized below (\$ in thousands):

<u>Consolidated Statements of Operations</u>	For the three months ended March 31, 2011		
	Previously Reported	Adjustment	Adjusted
Operating income	\$ 55,819	\$ 1,716	\$ 57,535
Excess of revenues over expenses	116,215	1,716	117,931
Change in plan assets and benefit obligations of pension and retiree health plans	2,875	(1,716)	1,159

Consolidated Inova Health System Operating Results and Other Financial Information

For the three months ended March 31, 2012, the Obligated Group represented approximately 93.5% of total operating revenues and 95.6% of net operating income of Inova Health System and its controlled affiliates.

For the three months ended March 31, 2012, operating income for Inova Health System was \$64.2 million, or 10.9% of operating revenues. Cash from operations was \$103.6 million.

The following are selected financial indicators for the System as of and for the three months ended March 31, 2012 (margin computations exclude losses on extinguishment of debt and interest swap terminations):

Operating Margin	10.9%
Operating Cash Flow Margin	18.0%
Days in Unrestricted Cash	572.9
Unrestricted Cash to Debt	3.1x
Debt to Capitalization	23.8%
Debt Service Coverage	7.4x

Inova Health System Obligated Group
Consolidated Balance Sheets
March 31, 2012 and December 31, 2011
(Dollars in thousands)

	<u>March 31, 2012</u>	<u>December 31, 2011</u>
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 188,811	\$ 239,404
Assets whose use is limited:		
By board for plant replacement and expansion	181,900	181,900
Patient accounts receivable less allowance for doubtful accounts	270,453	268,008
Third-party settlements	5,814	5,524
Other current assets	68,161	68,994
Total Current Assets	<u>715,139</u>	<u>763,830</u>
Property, Equipment and Leasehold Interest		
Land and land improvements	125,451	122,982
Buildings, fixed equipment and leasehold improvements	1,437,044	1,434,621
Major movable equipment	896,026	871,120
	<u>2,458,521</u>	<u>2,428,723</u>
Less allowances for depreciation and amortization	1,462,172	1,428,688
	<u>996,349</u>	<u>1,000,035</u>
Construction-in-progress	144,591	116,538
Total Property, Equipment and Leasehold Interest	<u>1,140,940</u>	<u>1,116,573</u>
Assets Whose Use Is Limited		
Held by bond trustee	73,683	96,473
By Board for plant replacement and expansion	2,790,388	2,554,220
By Donor	63,267	59,243
Total Assets Whose Use Is Limited	<u>2,927,338</u>	<u>2,709,936</u>
Less amounts required to meet current obligations	181,900	181,900
	<u>2,745,438</u>	<u>2,528,036</u>
Other Assets		
Unrestricted long-term investments	103,835	96,501
Investments in and receivables from affiliates	20,554	18,501
Deferred debt issuance costs	5,344	5,466
Pension asset - long-term	5,350	-
Other long-term assets	21,499	16,737
Total Other Assets	<u>156,582</u>	<u>137,205</u>
TOTAL ASSETS	<u>\$ 4,758,099</u>	<u>\$ 4,545,644</u>

Inova Health System Obligated Group
Consolidated Balance Sheets
March 31, 2012 and December 31, 2011
(Dollars in thousands)

	<u>2012</u>	<u>2011</u>
LIABILITIES AND NET ASSETS		
Current Liabilities		
Accounts payable and accrued expenses	\$ 148,066	\$ 157,173
Accrued salaries, wages and related items	113,932	104,997
Third-party settlements	58,250	55,793
Notes payable and other liabilities	102,764	103,138
Current portion of long-term debt	<u>204,181</u>	<u>204,168</u>
Total Current Liabilities	627,193	625,269
Non-current Liabilities		
Long-term debt, less current portion	774,322	776,884
Postemployment health care and retirement benefits	9,982	11,094
Interest rate swap liability	63,679	73,303
Other non-current obligations	20,694	20,380
Estimated professional liability	<u>19,561</u>	<u>19,297</u>
Total Non-current Liabilities	888,238	900,958
Net Assets		
Unrestricted	3,173,026	2,953,237
Temporarily restricted	41,034	38,943
Permanently restricted	<u>28,608</u>	<u>27,237</u>
Total Net Assets	<u>3,242,668</u>	<u>3,019,417</u>
 TOTAL LIABILITIES AND NET ASSETS	 <u><u>\$ 4,758,099</u></u>	 <u><u>\$ 4,545,644</u></u>

NOTE: The IHS Obligated Group includes Inova Health System Foundation; Inova Health Care Services excluding Inova VNA Home Care, Franconia-Springfield Surgery Center, LLC, Northern Virginia Surgery Center LLC, Inova Woodburn Surgery Center, LLC, and Springfield Healthplex Condominium Development, LLC; Inova Health System Services excluding Inova Physical Rehabilitation Services, UMC Holdings, Inc., Home Medical Essentials, LLC, McLean Assisted Living, LLC; Inova Alexandria Health Services Corporation excluding Alexandria Hospital Foundation and Alexandria Community Healthcare Group; and Loudoun Hospital Center. The IHS Obligated Group information presented above is derived from the audited consolidated financial statements of Inova Health System and excludes the accounts of all the Inova Health System non-obligated affiliates and subsidiaries.

Inova Health System Obligated Group
Consolidated Statements of Operations
For the Three Months Ended March 31, 2012 and 2011
(Dollars in thousands)

	2012	2011 (as adjusted [1])
Operating Revenues		
Net patient service revenue	\$ 554,881	\$ 541,840
Provision for bad debts	19,004	17,200
Net Patient Service Revenue Less Provision for Bad Debt	535,877	524,640
Other operating revenue	17,071	18,396
Total Operating Revenues	552,948	543,036
Operating Expenses		
Salaries and benefits	264,433	272,533
Other	187,049	172,065
Depreciation and amortization	31,993	32,353
Interest	8,064	8,550
Loss on extinguishment of debt and swap termination	-	-
Total Operating Expenses	491,539	485,501
Operating Income	61,409	57,535
Non-operating Revenues (Expenses)		
Investment income and other, net	54,365	60,396
Excess of revenues over expenses	115,774	117,931
Unrealized (losses) gains on investments, net	99,113	13,693
Change in fair value of effective hedging interest rate swaps	2,972	2,806
Change in plan assets and benefit obligations of pension and retiree health plans	1,952	1,159
Net assets released from restriction for purchase of equipment and land rights	-	-
Other	(22)	(45)
Increase in Unrestricted Net Assets	\$ 219,789	\$ 135,544

[1] Prior-year salaries and benefits have been adjusted to reflect a change in accounting method related to Inova's pension and other postretirement benefits. See Management Discussion and Analysis for further discussion.

NOTE: The IHS Obligated Group includes Inova Health System Foundation; Inova Health Care Services excluding Inova VNA Home Care, Franconia-Springfield Surgery Center, LLC, Northern Virginia Surgery Center LLC, Inova Woodburn Surgery Center, LLC, and Springfield Healthplex Condominium Development, LLC; Inova Health System Services excluding Inova Physical Rehabilitation Services, UMC Holdings, Inc., Home Medical Essentials, LLC, McLean Assisted Living, LLC; Inova Alexandria Health Services Corporation excluding Alexandria Hospital Foundation and Alexandria Community Healthcare Group; and Loudoun Hospital Center. The IHS Obligated Group information presented above is derived from the audited consolidated financial statements of Inova Health System and excludes the accounts of all the Inova Health System non-obligated affiliates and subsidiaries.

Inova Health System Obligated Group
Consolidated Statement of Cash Flows
For the Years Ended March 31, 2012 and 2011
(Dollars in thousands)

	2012	2011 (as adjusted [1])
Operating Activities		
Change in net assets	\$ 223,251	\$ 137,707
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	33,752	32,388
Change in plan assets and benefit obligations of pension and retiree health plans	(1,952)	(1,159)
Net realized and unrealized gains on investments	(133,604)	(63,627)
Other than temporary declines in market value of investments	2,441	2,988
Change in fair value of interest rate swaps	(9,624)	(3,483)
Equity investment earnings	(5,822)	(3,988)
Gain on sale of long-lived assets	(1,723)	-
Increase in accounts receivable and third-party settlements	(2,735)	(19,431)
Increase in accounts payable and other current liabilities	(7,025)	3,831
Increase in accrued salaries and wages	8,935	15,061
Decrease in pension & post employment benefits liability	(4,510)	(2,761)
Increase (decrease) in estimated professional liability and other deferred liab items	579	4,498
Increase (decrease) in minority interest	-	-
Restricted contributions received	(2,322)	(1,815)
Restricted interest and dividend income	(172)	(194)
Investment income, net of investment fees	-	-
Increase in other long-term assets	(3,842)	1,582
Net Cash Provided by Operating Activities	95,627	101,598
Investing Activities:		
Capital expenditures	(56,192)	(45,540)
Investments in and advances to joint ventures and affiliates	3,770	3,241
Proceeds from sale of fixed assets	-	-
Investment income, net of investment fees	-	-
Purchases of marketable securities	(883,150)	(964,953)
Proceeds from sale of marketable securities	789,577	851,159
Other	(170)	-
Net Cash Used in Investing Activities	(146,165)	(156,093)
Financing Activities:		
Restricted contributions received	2,322	1,815
Restricted interest and dividend income	172	194
Principal payments on long-term debt	(2,569)	(2,388)
Proceeds from issuance of long-term debt	-	-
Refunding of long-term debt	-	-
Proceeds from short term borrowings	-	-
Principal payments on short-term borrowings	-	-
Debt issuance costs	-	-
Cash collateral held by swap counterparties	-	-
Swap termination receipts (payments)	-	(2,455)
Other	20	19
Net Cash (Used in) provided by Financing Activities	(55)	(2,815)
Net Increase in Cash and Cash Equivalents	(50,593)	(57,310)
Cash and Cash Equivalents at Beginning of Year	239,404	227,758
Cash and Cash Equivalents at End of Year	\$ 188,811	\$ 170,448

NOTE: The IHS Obligated Group includes Inova Health System Foundation; Inova Health Care Services excluding Inova VNA Home Care, Franconia-Springfield Surgery Center, LLC, Northern Virginia Surgery Center LLC, Inova Woodburn Surgery Center, LLC, and Springfield Healthplex Condominium Development, LLC; Inova Health System Services excluding Inova Physical Rehabilitation Services, UMC Holdings, Inc., Home Medical Essentials, LLC, McLean Assisted Living, LLC; Inova Alexandria Health Services Corporation excluding Alexandria Hospital Foundation and Alexandria Community Healthcare Group; and Loudoun Hospital Center. The IHS Obligated Group information presented above is derived from the audited consolidated financial statements of Inova Health System and excludes the accounts of all the Inova Health System non-obligated affiliates and subsidiaries.