

TO: Interested Parties

FROM: Lynn Green, Director of Financial Reporting

SUBJ: Management Discussion of Operations
First Quarter Fiscal 2017

DATE: February 17, 2017

SUMMARY

Net income for the three months ending December 30, 2017 was \$50.0 million compared to \$48.3 million for the same period last year. The net income margin was 11.8% compared to 12.9% last year. Net income for this year includes favorable changes in the market value of the interest rate SWAP of \$19.6 million compared to \$2.0 million favorable last year. Excluding the change in the unrealized SWAP market valuation, net income is \$30.4 million this year compared to \$46.3 million last year. The net income margin, excluding the SWAP, would be 7.5% compared to 12.5% last year. Income from operations was \$35.2 million, less than last year by \$13.3 million (27.4%). The operating income margin was 8.9% compared to 13.3% last year.

Total operating revenue exceeded last year by \$31.9 million (8.7%) because of volume growth, favorable payor mix, managed care rate increases, increased Medicaid Waiver UC and Medicaid Waiver DSRIP payments recognized, and the addition of a new hospital joint venture (\$14.2 million), offset by greater charity and bad debts and lower Medicaid DSH payments recognized. Charity and bad debts represented approximately 32.9% of non-governmental revenue, 0.4 points greater than last year (1.3%).

Patient volume was greater than last year. The number of patients in beds increased over last year; however, the number of patients whose status is determined to be inpatient increased only slightly while the number assigned outpatient observation status had a large increase. The status change is occurring as a result of Medicare redefining inpatient status assignment for Medicare patients resulting in greater assignment to outpatient status.

- The number of inpatients (excluding observation patients) exceeded last year (0.1%).
- Inpatient days (excluding observation and newborn border days) exceeded last year by 2.6%.
- Equivalent inpatients exceeded last year by 5.5%.
- Equivalent inpatient days exceeded last year by 7.0%.
- The number of observation patients exceeded last year by 14.2%.
- The number of observation days of care exceeded last year by 35.7%.

MANAGEMENT DISCUSSION OF OPERATIONS FIRST QUARTER FY17 (Continued)

- Emergency Department visits increased from last year by 2.6%.
- Outpatient visits was lower than last year by 2.0%.

Operating expenses exceeded last year by \$45.2 million (14.2%) because of volume growth, inflation, increased number of employees, depreciation on a new bed tower which opened last December on the Mansfield campus (\$1.8 million), and the addition of a new hospital joint venture (\$11.6 million).

Non-operating income, excluding the favorable changes in interest rate SWAP valuations of \$19.6 million this year compared to \$2.0 million favorable last year, was a gain of \$5.0 million compared to a gain of \$5.4 million last year. Non-operating income includes gains on investments of \$13.9 million compared to \$10.7 million last year, and interest expense of \$7.7 million compared to \$5.1 million last year.

Net income attributable to non-controlling interests is \$9.9 million this year compared to \$7.6 million last year.

Methodist Health System
Consolidated Financial Statements
December 31, 2016

METHODIST HEALTH SYSTEM - Consolidated BALANCE SHEETS

	<u>December, 31</u>	
	<u>2016</u>	<u>2015</u>
ASSETS	(In Thousands)	
Current assets:		
Cash and cash equivalents	\$ 31,441	\$ 22,886
Short-term investments	826,684	807,969
Patient accounts receivable net of allowance for uncollectible accounts of \$225,276 - 2016 and \$186,899 - 2015	224,338	215,007
Other accounts receivable	31,037	57,878
Other current assets	<u>49,119</u>	<u>43,021</u>
Total current assets	1,162,619	1,146,761
Long-term investments	122,297	50,418
Net property, plant, and equipment	913,203	799,087
Assets whose use is limited	64,074	64,521
Other assets	<u>27,201</u>	<u>26,778</u>
Total assets	<u>\$2,289,394</u>	<u>\$2,087,565</u>
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable and accrued expenses	\$ 124,967	\$ 116,926
Accrued construction costs	378	9,383
Health insurance programs reimbursement payable	3,678	3,996
Current installments of long-term debt	<u>10,872</u>	<u>11,003</u>
Total current liabilities	139,895	141,308
Long-term debt	524,991	449,097
Interest rate swaps liability	48,723	53,171
Other liabilities	<u>39,072</u>	<u>30,265</u>
Total liabilities	752,681	673,841
Net assets		
Unrestricted	1,479,650	1,365,523
Unrestricted net assets attributable to noncontrolling interests	18,911	11,164
Temporarily restricted	32,478	32,767
Permanently restricted	<u>5,674</u>	<u>4,270</u>
Total net assets	<u>1,536,713</u>	<u>1,413,724</u>
Total liabilities and net assets	<u>\$2,289,394</u>	<u>\$2,087,565</u>

METHODIST HEALTH SYSTEM - Consolidated STATEMENTS OF REVENUES AND EXPENSES

	For the Three Months Ended December 31,	
	<u>2016</u>	<u>2015</u>
	(In Thousands)	
Net patient service revenue before provision for bad debts	\$ 418,024	\$ 382,147
Provision for bad debts	<u>(33,494)</u>	<u>(33,956)</u>
Net patient service revenue after provision for bad debts	384,530	348,191
Other operating revenue	<u>13,139</u>	<u>17,564</u>
Total operating revenue	397,669	365,755
Operating expenses		
Salaries, wages and benefit costs	183,650	160,115
Other operating expenses	154,606	136,645
Interest	-	-
Depreciation & amortization	<u>24,198</u>	<u>20,493</u>
Total operating expenses	<u>362,454</u>	<u>317,253</u>
Income from operations	35,215	48,502
Nonoperating gains, net	<u>24,636</u>	<u>7,367</u>
Excess of revenues over expenses	59,851	55,869
Excess of revenues over expenses attributable to noncontrolling interests	<u>(9,885)</u>	<u>(7,582)</u>
Excess of revenues over expenses attributable to Methodist Health System	<u>\$ 49,966</u>	<u>\$ 48,287</u>

**METHODIST HEALTH SYSTEM - Consolidated
STATEMENTS OF CHANGES IN NET ASSETS**

	For the Three Months Ended December 31,	
	<u>2016</u>	<u>2015</u>
	(In Thousands)	
Unrestricted net assets:		
Balance at beginning of period	\$ 1,441,570	\$ 1,322,725
Excess of revenue over expenses	49,966	48,287
Changes attributable to noncontrolling interests	6,248	5,307
Net assets released from restrictions used for capital	<u>777</u>	<u>368</u>
Balance at end of period	1,498,561	1,376,687
Temporarily restricted net assets:		
Balance at beginning of period	31,784	31,971
Restricted grant, gifts & bequest	1,363	1,120
Income from investments	491	736
Decrease in net assets of related foundation	347	23
Transfer to/from permanently restricted net assets	(81)	-
Net assets released from restrictions	<u>(1,426)</u>	<u>(1,082)</u>
Balance at end of period	32,478	32,768
Permanently restricted net assets:		
Balance at beginning of period	5,572	4,270
Income from investments	21	-
Transfer to/from temporarily restricted net assets	<u>81</u>	<u>-</u>
Balance at end of period	<u>5,674</u>	<u>4,270</u>
Net assets - beginning of period	1,478,926	1,358,966
Increase in net assets	<u>57,787</u>	<u>54,759</u>
Net assets - end of period	<u>\$ 1,536,713</u>	<u>\$ 1,413,725</u>

METHODIST HEALTH SYSTEM - Consolidated STATEMENTS OF CASH FLOWS

For the Three Months Ended December 31,

2016 2015

(In Thousands)

Cash flows from operating activities:

Increase in net assets	\$ 57,787	\$ 54,759
Adjustments to reconcile change in net assets to net cash and cash equivalents provided by operating activities:		
Operating depreciation and amortization	24,198	20,493
Nonoperating depreciation and amortization	1,316	1,356
Provision for bad debts	33,494	33,956
Capitalized interest	(425)	(847)
Unrealized (gains) losses on interest rate swaps	(19,609)	(2,008)
Unrealized and realized gains on investments	(8,776)	(4,575)
Restricted gifts, grants, and bequests and change in interest in the net assets of related foundation	(1,710)	(1,143)
Changes in operating assets and liabilities:		
Increase in patient accounts receivable	(47,724)	(56,908)
(Increase) decrease in other accounts receivable	(2,164)	24,325
Increase in other current assets	(5,485)	(5,230)
(Increase) decrease in other assets	(440)	2,127
Decrease in accounts payable and accrued expenses	(24,421)	(12,158)
Increase (decrease) in health insurance programs reimbursement payable	395	(102)
Increase in other liabilities	1,465	451
Net cash provided by operating activities	7,901	54,496

Cash flows from investing activities:

Purchases of investments	(91,300)	(124,010)
Maturities and sales of investments	81,921	97,383
Purchases of property, plant and equipment	(25,660)	(42,123)
Cash (invested in) withdrawn from assets whose use is limited	(790)	208
Net cash used in investing activities	(35,829)	(68,542)

Cash flows from financing activities:

Principal payments on debt	(7,447)	(7,950)
Issuance of debt	2	133
Restricted gifts, grants, and bequests and change in interest in the net assets of related foundation	1,710	1,143
Net cash used in financing activities	(5,735)	(6,674)

Net decrease in cash and cash equivalents

Cash and cash equivalents, beginning of year

Cash and cash equivalents, end of year

(33,663)	(20,720)
65,104	43,606
\$ 31,441	\$ 22,886

**Methodist Health System
Obligated Group Financial Statements
December 31, 2016**

METHODIST HEALTH SYSTEM - Obligated Group

BALANCE SHEETS

	<u>December 31,</u>	
	<u>2016</u>	<u>2015</u>
ASSETS	(In Thousands)	
Current Assets:		
Cash and cash equivalents	\$ 14,804	\$ 8,814
Short-term investments	759,780	745,361
Patient accounts receivable net of allowance for uncollectible accounts of \$197,841 - 2017 and \$169,638 - 2016	164,320	176,050
Other accounts receivable	50,025	52,816
Other current assets	<u>39,805</u>	<u>36,786</u>
Total current assets	1,028,734	1,019,827
Long-term investments	122,297	50,418
Net property, plant, and equipment	716,870	708,473
Assets whose use is limited	21,093	24,206
Other assets	<u>51,190</u>	<u>38,905</u>
Total assets	<u>\$1,940,184</u>	<u>\$1,841,829</u>
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable and accrued expenses	\$ 92,621	\$ 85,947
Accrued construction costs	378	9,383
Health Insurance Program reimbursement payable	3,432	3,226
Current installments of long-term debt	<u>6,744</u>	<u>6,458</u>
Total current liabilities	103,175	105,014
Long-term debt	350,420	357,675
Interest rate swaps liability	48,723	53,171
Other liabilities	<u>27,940</u>	<u>23,996</u>
Total liabilities	530,258	539,856
Net assets		
Unrestricted	1,409,926	1,299,823
Unrestricted net assets attributable to noncontrolling interest	-	2,000
Temporarily restricted	<u>-</u>	<u>150</u>
Total net assets	<u>1,409,926</u>	<u>1,301,973</u>
Total liabilities and net assets	<u>\$1,940,184</u>	<u>\$1,841,829</u>

METHODIST HEALTH SYSTEM - Obligated Group
STATEMENTS OF REVENUES AND EXPENSES

	For the Three Months Ended December 31,	
	<u>2016</u>	<u>2015</u>
	(In Thousands)	
Net patient service revenue before provision for bad debts	\$ 304,432	\$ 299,017
Provision for bad debts	<u>(27,911)</u>	<u>(30,129)</u>
Net patient service revenue after provision for bad debts	276,521	268,888
Other operating revenue	<u>23,453</u>	<u>25,812</u>
Total operating revenue	299,974	294,700
Operating expenses:		
Salaries, wages and benefit costs	150,913	136,391
Other operating expenses	104,770	98,521
Depreciation and amortization	<u>20,421</u>	<u>18,608</u>
Total operating expenses	<u>276,104</u>	<u>253,520</u>
Income from operations	23,870	41,180
Nonoperating gains, net	<u>24,497</u>	<u>5,056</u>
Excess of revenue over expenses	48,367	46,236
Excess of revenue over expenses attributable to noncontrolling interests	<u>325</u>	<u>29</u>
Excess of revenue over expenses attributable to Methodist Health System	<u>\$ 48,692</u>	<u>\$ 46,265</u>

METHODIST HEALTH SYSTEM - Obligated Group
STATEMENTS OF CHANGES IN NET ASSETS

For the Three Months Ended December 31,

2016

2015

(In Thousands)

Unrestricted net assets:

Balance at beginning of period	\$ 1,360,733	\$ 1,253,527
Excess of revenue over expenses	48,692	46,265
Changes attributable to noncontrolling interests	-	2,000
Donations for specific additions to capital	500	31
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Balance at end of period	1,409,926	1,301,823

Temporarily restricted net assets:

Balance at beginning of period	-	-
Restricted grant, gifts & bequest	-	150
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Balance at end of period	-	150

Net assets - beginning of period

1,360,733

1,253,527

Increase in net assets

49,193

48,446

Net assets - end of period

\$ 1,409,926

\$ 1,301,973

METHODIST HEALTH SYSTEM - Obligated Group
STATEMENTS OF CASH FLOWS

For the Three Months Ended December 31,

2016 2015

(In Thousands)

Cash flows from operating activities:

Increase in net assets	\$ 49,193	\$ 48,446
Adjustments to reconcile change in net assets to net cash and cash equivalents provided by operating activities:		
Operating depreciation and amortization	20,421	18,608
Nonoperating depreciation and amortization	1,230	1,258
Provision for bad debts	27,911	30,129
Capitalized interest	(425)	(847)
Unrealized (gains) losses on interest rate swaps	(19,609)	(2,008)
Unrealized and realized gains on investments	(7,438)	(2,849)
Restricted gifts, grants, and bequests	-	(150)
Changes in operating assets and liabilities:		
Increase in patient accounts receivable	(24,391)	(43,516)
Increase (decrease) in health insurance programs reimbursement payable	327	(315)
(Increase) decrease in other accounts receivable	(13,105)	24,862
Increase in other current assets	(4,485)	(4,013)
Increase in other assets	(7,434)	(3,407)
Decrease in accounts payable and accrued expenses	(17,221)	(14,843)
Increase (decrease) in other liabilities	821	(190)
Net cash provided by operating activities	<u>5,795</u>	<u>51,165</u>

Cash flows from investing activities:

Purchases of investments	(91,095)	(123,657)
Maturities and sales of investments	81,921	97,387
Purchases of property, plant and equipment	(22,641)	(41,070)
Cash provided by assets whose use is limited	98	1,010
Net cash used in investing activities	<u>(31,717)</u>	<u>(66,330)</u>

Cash flows from financing activities:

Principal payments on debt	(6,497)	(6,279)
Restricted gifts, grants, and bequests	-	150
Net cash used in financing activities	<u>(6,497)</u>	<u>(6,129)</u>

Net decrease in cash and cash equivalents

Cash and cash equivalents, beginning of year

Cash and cash equivalents, end of year

	(32,419)	(21,294)
	47,221	30,108
	<u>\$ 14,802</u>	<u>\$ 8,814</u>