

LAHEY HEALTH SYSTEM
Financial Statement Discussion and Analysis

For the Six Months Ended March 31, 2017

Introduction

The attached combined financial statements of Lahey Health System (Lahey) reflect an operating loss of \$37.3M compared to a loss of \$3.3M for the six months ended March 31, 2017. The unfavorable change compared to prior year of \$34.1M resulted from expenses that have increased at a greater rate than revenues. Total changes in unrestricted net assets resulted in a loss of \$13.5M compared to a gain of \$6.6M during the same period in the prior year. The unfavorable change in unrestricted net assets compared to prior year of \$20.0M resulted from non-operating gains of \$25.0M, offset by decreases in unrealized gain/ losses of \$9.2M, and decreases in assets released from restrictions of \$1.8M and an unfavorable change in income from operations of \$34.1M.

Balance Sheet

The combined balance sheet as of March 31, 2017 shows a decrease in total assets of \$39.8M from September 30, 2016. The principal reasons for the change were decreases in cash and investments of \$34.8M, decreases in pledge receivables of \$5.6M, decreases in MDFA project funds of \$7.9M and decreases in property plant and equipment of \$13.8M, offset by increases in patient account receivables of \$7.2M, increases in inventories and prepaid expenses of \$9.5M, increases in other receivables of \$3.3M and increases in other investments of \$2.0M. Unrestricted cash and investments decreased by \$47.9M to \$822.2M, day's cash on hand decreased 16 days to 152.

Liabilities decreased by \$31.1M and net assets decreased by \$8.8M. The decreases in liabilities were primarily due to decreases in accounts payable and accrued expenses of \$.8M, decreases in accrued payroll and benefits of \$23.9M, decreases in long and short term debt of \$2.1M, decreases in accrued pension and postretirement benefits of \$1.3M and decreases in other liabilities of \$6.9M, offset by increases in third party liabilities of \$3.8M. The decrease in net assets resulted from a decrease in total income of \$13.5M, offset by net increases in restricted donations and unrealized gains and losses on investments of \$4.7M.

The cash-to-debt ratio decreased in comparison to prior year end moving from 154.0% at September 30, 2015 to 146.9% at March 31, 2017. The debt to capitalization ratio increased from 44.1% at September 30, 2016 to 44.5% at March 31, 2017.

Statement of Operations Patient volumes for the six months ended March 31, 2017 showed hospital inpatient discharges increasing 1.4% to 29,294 and the average length of stay increased 1.8% to 4.45 days. Hospital outpatient volumes showed emergency service visits decreased 0.9% to 98,971, ambulatory surgical cases decreased 4.5% to 13,215 and observation patients decreased 0.4% to 8,286. The group practice showed outpatient appointments decreased 3.3% to 623,036 and work relative value units decreased 2.1% to 1,906,500. The decline in outpatient appointments was related to a lower physician complement.

Operating revenues increased 1.3% to \$1,001.5M compared to the same period in the prior year. The 1.3% increase was mainly due to increases in discharges and private duty billable hours, offset by decreases in emergency visits, work relative value units, ambulatory surgery procedures, outpatient appointments, rehabilitation and skilled nursing occupancy, assisted living occupancy, home care patient visits and ambulatory behavioral health activity. The net decreases in volume were offset by payor rate increases net of a reduction in the Medicare area wage index plus patient mix changes and revenue cycle improvements.

Operating expenses increased 4.7% to \$1,038.8M compared to the same period in the prior year. Salaries and wages increased 5.1% to \$495.7M. Full time equivalents for non-physicians increased by 176 and physician FTE's decreased by 3. Employee benefits increased 4.9% to \$130.1M. The primary increase was due to increases in health insurance and dental expenses of \$4.4M and social security FICA expenses of \$1.5M. Supplies and other services increased 2.9% to \$336.4M. The increase of \$10.0M was due primarily to increases in pharmaceutical costs of \$8.4M, prosthetic expenses of \$3.3M, endoscopic supplies of \$1.5M and collection services of \$1.7M, offset by decreases in travel and tanning of \$2.2M and all other expenses of \$2.7M. Capital costs including depreciation and interest decreased by 1.6% to \$52.6M. The health safety net assessment increased 131.2% to \$14.4M due to an additional assessment implemented by the state of Massachusetts on all acute care hospitals.

Non-operating gains (losses) increased from prior year by \$25.0M to a gain of \$41.8M. Investment income increased by \$19.5M, other income increased by \$6.9M and unrestricted contributions, net decreased by \$1.4M.

Other changes in unrestricted net assets decreased from prior year by \$20.0M to a loss of \$13.5M. Unrealized losses on investments decreased by \$9.2M and assets released from restriction decreased by \$1.8M.

Conclusion

The six months ended March 31, 2017 volumes for the period showed mixed results with increases in discharges and private duty billable hours, offset by decreases in emergency visits, ambulatory surgery procedures, outpatient appointments, rehabilitation and skilled nursing occupancy, home care patient visits, assisted living occupancy, and ambulatory behavioral health activity. Overall rate increases in revenue attributable to patient mix and revenue cycle improvements were offset by higher expenses resulting in a net loss from operations of \$37.3M. Non-operating gains (losses) were positive by \$28.3M, which when combined with the operating results generated an overall loss in income of \$13.5M. Because cost increases have outpaced revenue growth, management has developed an improvement plan that is being implemented in the remaining months of the fiscal year.

LAHEY HEALTH SYSTEM, INC and AFFILIATES

Consolidated Balance Sheet

<i>in thousands</i>	Unaudited March 31, 2017	Audited September 30, 2016
Current assets		
Cash and equivalents	\$ 175,994	\$ 243,077
Short-term investments		
Patient accounts receivable, net	181,152	173,968
Inventories	23,655	23,007
Prepaid expenses	28,209	19,380
Pledges receivable	7,573	11,049
Current portion of assets whose use is limited or restricted	4,224	2,363
Other receivables	<u>23,031</u>	<u>19,682</u>
Total current assets	443,838	492,526
Assets whose use is limited		
Board designated depreciation funds	75,939	74,804
Board designated education funds	4,777	4,337
Assets held by trustee under bond indenture agreement	4,911	6,061
MDFA project funds	31,469	39,320
Assets held in professional liability trust	81,104	81,104
Temporary restricted investments	90,037	80,722
Permanently restricted investments	75,640	71,841
Investments, other	<u>38,796</u>	<u>36,795</u>
Total non-current assets, limited use	402,673	394,984
Property, plant and equipment, net	855,722	869,557
Deferred debt issue cost, net	5,796	5,996
Other assets, net	59,965	60,377
Professional insurance receivable	2,135	2,135
Long-term investments	565,540	547,970
Assets held under split interest agreements	12,600	12,316
Beneficial interest in perpetual lead trusts	38,495	38,665
Pledges receivable, net	<u>14,941</u>	<u>17,023</u>
Total assets	<u>\$ 2,401,705</u>	<u>\$ 2,441,549</u>

LAHEY HEALTH SYSTEM, INC and AFFILIATES

Consolidated Balance Sheet

<i>in thousands</i>	Unaudited March 31, 2017	Audited September 30, 2016
Current liabilities		
Accrued expenses	94,604	95,427
Accrued payroll and benefits	171,182	195,033
Accrued interest on bonds payable	2,687	2,665
Current portion of long-term debt	23,909	23,856
Due to third party payors	<u>33,574</u>	<u>29,780</u>
Total current liabilities	\$ 325,956	\$ 346,761
Long-term debt	539,261	541,385
Accrued pension benefits	446,609	448,862
Accrued post retirement benefits	34,935	33,973
Professional liability reserves	69,623	69,623
Due to third party payors	23,779	23,779
Other liabilities	<u>25,156</u>	<u>32,029</u>
Total long-term liabilities	1,139,363	1,149,651
Net assets		
Unrestricted	703,694	717,176
Temporarily restricted	151,607	147,274
Permanently restricted	<u>81,085</u>	<u>80,687</u>
Total net assets	936,386	945,137
Total liabilities and net assets	<u>\$ 2,401,705</u>	<u>\$ 2,441,549</u>

LAHEY HEALTH SYSTEM, INC and AFFILIATES
Consolidated Statement of Operations

<i>in thousands</i>	Unaudited March 31, 2017	Unaudited March 31, 2016
Operating revenues		
Net patient service revenues	956,855	943,853
Other operating revenues	44,607	44,681
Total	1,001,462	988,534
Operating expenses		
Salaries and wages	382,008	365,274
Physicians salaries and wages	113,708	106,191
Employee benefits	130,127	124,100
Supplies and Other	336,352	326,782
Depreciation	52,645	53,548
Interest	9,558	9,678
Health safety net assessment	14,407	6,231
Administrative and other costs	-	-
Total	1,038,805	991,804
Income (loss) from operations	(37,343)	(3,270)
Nonoperating gains (losses)		
Investment income	39,744	20,231
Unrestricted contributions, net	(3,152)	(1,739)
Contribution revenue from acquisition	-	-
Other (expenses) income	5,201	(1,703)
Total non operating gains (losses)	41,793	16,789
Excess of revenues over expenses	4,450	13,519
Unrealized gains (losses) on investments	(18,940)	(9,762)
Assets released from restrictions	1,009	2,811
	(13,481)	6,568
Pension and postretirement related changes other than net periodic costs	-	-
Loss on interest rate swaps	-	-
Change in unrestricted net assets	<u>\$ (13,481)</u>	<u>\$ 6,568</u>

LAHEY HEALTH SYSTEM, INC and AFFILIATES

Statement of Cash Flows

in thousands

	Unaudited	Audited
	March 31, 2017	September 30, 2016
	<u> </u>	<u> </u>
Cash flows from operating activities		
Change in net assets	\$ (8,751)	\$ (83,009)
Adjustments to reconcile change in net assets to net cash provided by operating activities		
Contribution revenue from acquisition	-	-
Net realized and unrealized gains (losses) on investments	(13,926)	(44,161)
Change in value of investments accounted for under the equity method of accounting	(3,147)	(9,974)
Change in value of interest rate swaps	(6,877)	3,445
Depreciation and amortization	51,795	104,202
Premium in issuance of debt	-	28,313
Loss on extinguishment of debt	-	2,951
Provision for bad debts	23,531	47,712
Change in value of split interest agreements, perpetual, and lead trusts	(114)	(2,750)
Pension and postretirement related changes other than net periodic benefit cost	-	144,299
(Gain) loss on sale of property, plant and equipment	-	610
Net gain on equity investment in joint ventures	(2,234)	(5,527)
Restricted contributions	(1,295)	(9,257)
Donated securities	(1,951)	(1,663)
Proceeds from sale of donated securities	1,392	118
Professional insurance receivable	-	(178)
Changes in operating assets and liabilities		
Patient accounts receivable	(30,715)	(39,916)
Inventories of supplies, prepaid expenses and other assets	(10,188)	1,828
Pledges and other receivables	2,208	8,417
Accounts payable, accrued expenses, and other liabilities	(16,983)	(21,382)
Accrued postretirement benefits and pension costs	(17,833)	(1,859)
Professional liability reserves	-	(6,114)
Estimated third-party settlements	3,794	(2,534)
Net cash provided by operating activities	<u>(31,294)</u>	<u>113,571</u>
Cash flows from investing activities		
Cash received through acquisition	-	-
Additions to property, plant, and equipment	(38,810)	(103,098)
Proceeds from sale of property, plant, and equipment	-	1,674
Purchase of assets whose use is limited and long-term investments	(145,898)	(234,618)
Proceeds from sale of assets whose use is limited and long-term investments	137,589	214,150
Increase in construction funds from new borrowings	-	-
Use of construction funds	7,851	(39,320)
Distributions from joint ventures	2,514	8,100
Change in other assets	132	(923)
Net cash used in investing activities	<u>(36,622)</u>	<u>(154,035)</u>
Cash flows from financing activities		
Restricted contributions	1,295	9,257
Proceeds from sale of donated securities restricted for endowment	559	1,545
Proceeds from bond issuance	-	234,515
Repayment of long-term debt	-	(178,365)
Payment of notes payable	(197)	(469)
Proceeds from note	-	-
Payment of note	-	(30,000)
Debt issuance costs	200	(3,057)
Principal payments of capital lease obligations	(1,024)	(1,982)
Net cash provided by (used in) financing activities	<u>833</u>	<u>31,444</u>
Net decrease in cash and cash equivalents	(67,083)	(9,020)
Cash and cash equivalents		
Beginning of year	243,077	252,097
End of year	<u>\$ 175,994</u>	<u>\$ 243,077</u>

LAHEY HEALTH SYSTEM, INC and AFFILIATES

Payor Mix

<i>Percent of Gross Revenue</i>	Unaudited March 31, 2017	Unaudited March 31, 2016
Payor		
Blue Cross	16.0%	16.3%
Commercial	2.1%	2.3%
Managed care	22.9%	23.1%
Medicaid	10.0%	10.0%
Medicare	34.8%	34.5%
Medicare managed care	10.7%	10.6%
Other	2.4%	2.2%
Self Pay	<u>1.1%</u>	<u>1.2%</u>
Total	<u>100.0%</u>	<u>100.0%</u>

LAHEY HEALTH SYSTEM, INC and AFFILIATES

Utilization Statistics

	Unaudited	Unaudited
	March 31, 2017	March 31, 2016
Group practice		
Occasion of services (appointments)	623,036	644,625
Work relative value units	1,906,500	1,947,886
Hospital inpatient services		
Licensed beds	978	978
Discharges	29,294	28,889
Patient days	130,282	126,257
Average length of stay (days)	4.45	4.37
Average daily census	716	690
Occupancy percent (licensed beds)	73.19%	70.54%
Hospital outpatient services		
Emergency service visits	98,971	99,841
Ambulatory surgical procedures	13,215	13,839
Observation patients	8,286	8,257
Continuing Care		
Seacoast occupancy percent	88.8%	89.0%
Ledge wood occupancy percent	89.6%	86.0%
Herrick House occupancy percent	80.6%	85.0%
Home care patient visits	102,470	103,252
Private duty billable hours	28,746	26,130
Client days	5,429	5,616
Lifeline subscriptions	2,561	2,490
Hospice average daily census	65	67
Spectrum average daily census	78	84
Behavioral services		
Youth services	7,750	10,122
Emergency services	76,029	92,723
CBHI and family support	165,243	265,941
Ambulatory services	132,802	139,062
Psychopharmacology	33,490	10,759
Addiction services	118,585	137,096
Total	<u>533,899</u>	<u>655,703</u>

LAHEY HEALTH SYSTEM, INC and AFFILIATES

Proforma Ratios

in thousands

	Unaudited	Audited
	March 31, 2017	September 30, 2016
Capitalization ratio		
Total long-term indebtedness	563,170	565,241
+ Unrestricted net assets	703,694	717,176
= Total capitalization	\$ 1,266,864	\$ 1,282,417
Total long-term indebtedness	\$ 563,170	\$ 565,241
÷ Total capitalization	\$ 1,266,864	\$ 1,282,417
= Net long-term indebtedness to capitalization ratio	44.45 %	44.08
Liquidity ratio		
Cash, marketable securities and board designated funds	\$ 822,190	\$ 870,188
Days cash on hand	152.0	168.0
Debt service coverage ratio		
Excess of revenue over expenses	\$ 4,450	\$ 73,591
+ Depreciation and amortization	52,645	94,645
+ Interest expense	9,558	17,220
= Income (loss) available for debt service	\$ 66,653	\$ 185,456
÷ Maximum annual debt service on all LTD	\$ 44,639	\$ 44,639
= Maximum annual debt service coverage (times) *(365 days / 182 days)	2.99	4.15

LAHEY HEALTH
Combining Statement of Operations (Year-To-Date)
Six Months Ending March 31, 2017

Year-To-Date

\$ / 000s	Lahey Med Ctr	Northeast Hospital	Winchester Healthcare	Community Practices	Population Health	Continuing Care	Behavioral Services	System Services	Other Services	Eliminating Entries	System Total
Operating revenues											
Net patient service revenue	565,555	178,916	151,491	1,281	703	28,778	30,131	-	-	-	956,855
Other revenues	26,390	6,315	8,269	132	2,386	406	9,012	96,515	834	(111,599)	38,660
Net assets released from restrictions	<u>4,075</u>	<u>758</u>	<u>712</u>	<u>-</u>	<u>-</u>	<u>215</u>	<u>186</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>5,946</u>
Total operating revenues	596,020	185,989	160,472	1,413	3,089	29,399	39,329	96,515	834	(111,599)	1,001,461
Operating expenses											
Salaries and wages, non-physicians	167,933	73,780	63,467	672	22	17,030	25,712	41,168	-	(7,777)	382,007
Salaries and wages, physicians	97,508	6,185	8,275	878	-	11	1,551	330	-	(1,030)	113,708
Employee benefits	72,730	18,490	17,671	358	185	3,637	5,589	13,360	-	(1,893)	130,127
Supplies and services	167,234	56,983	56,322	330	4,263	6,855	6,857	46,216	834	(9,602)	336,292
Depreciation and other	34,162	8,777	8,629	9	-	568	475	19	7	-	52,646
Interest	5,194	1,723	2,296	-	-	336	69	-	-	-	9,618
Health safety net assessment	9,354	2,140	2,912	-	-	-	-	-	-	(60)	14,346
System services	<u>71,707</u>	<u>18,996</u>	<u>2,683</u>	<u>261</u>	<u>-</u>	<u>714</u>	<u>1,209</u>	<u>1,001</u>	<u>-</u>	<u>(96,509)</u>	<u>62</u>
Total operating expenses	625,822	187,074	162,255	2,508	4,470	29,151	41,462	102,094	841	(116,871)	1,038,806
Income (loss) from operations	<u>(29,802)</u>	<u>(1,085)</u>	<u>(1,783)</u>	<u>(1,095)</u>	<u>(1,381)</u>	<u>248</u>	<u>(2,133)</u>	<u>(5,579)</u>	<u>(7)</u>	<u>5,272</u>	<u>(37,345)</u>
Nonoperating gains (losses), net											
Investment income	7,382	15,624	16,956	(4)	(7)	358	(40)	(797)	271	-	39,743
Unrestricted contributions	1,688	351	343	-	-	56	12	-	-	-	2,450
Net assets released from restrictions	46	-	-	-	-	-	-	-	-	-	46
Fundraising costs	-	-	(357)	-	-	(20)	-	-	-	(5,272)	(5,649)
Other income (expense)	<u>518</u>	<u>4,784</u>	<u>65</u>	<u>-</u>	<u>-</u>	<u>1</u>	<u>(2)</u>	<u>374</u>	<u>(539)</u>	<u>-</u>	<u>5,201</u>
Total nonoperating gains (losses)	<u>9,634</u>	<u>20,759</u>	<u>17,007</u>	<u>(4)</u>	<u>(7)</u>	<u>395</u>	<u>(30)</u>	<u>(423)</u>	<u>(268)</u>	<u>(5,272)</u>	<u>41,791</u>
Excess (deficiency) of revenues over expenses	(20,168)	19,674	15,224	(1,099)	(1,388)	643	(2,163)	(6,002)	(275)	-	4,446
Other changes in unrestricted net assets											
Net unrealized gains and losses on investments	640	(7,854)	(11,992)	-	-	267	-	-	-	-	(18,939)
Net assets released from restrictions PP&E	360	343	306	-	-	-	-	-	-	-	1,009
Transfer of net assets	-	-	(493)	-	-	493	-	-	-	-	-
Total other changes in unrestricted net assets	<u>1,000</u>	<u>(7,511)</u>	<u>(12,179)</u>	<u>-</u>	<u>-</u>	<u>760</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(17,930)</u>
Increase (decrease) in unrestricted net assets	<u>(19,168)</u>	<u>12,163</u>	<u>3,045</u>	<u>(1,099)</u>	<u>(1,388)</u>	<u>1,403</u>	<u>(2,163)</u>	<u>(6,002)</u>	<u>(275)</u>	<u>-</u>	<u>(13,484)</u>