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November 11, 2010

Memorandum to the Michigan Attorney General's Office Regarding Issues Raised by the Service Employees International Union in Connection with the Proposed Sale of the Detroit Medical Center

OVERVIEW

The Service Employees International Union ("SEIU") sent a series of letters to the Michigan Attorney General's office in which it raised several concerns regarding the proposed acquisition of the Detroit Medical Center ("DMC") by Vanguard Health Systems ("VHS"). The Michigan Attorney General's Office asked AlixPartners to review and comment on the SEIU letters.

The first letter, dated September 27, 2010 (the "September Letter"), focused on valuation issues, alleging that the purchase price for the DMC is too low[1], and the capital spending pledge by Vanguard is below average.[2] A follow-up letter, dated October 13, 2010 (the "October 13th Letter"), further elaborated on the SEIU's position that the purchase price for DMC is too low. Subsequently, the SEIU sent a letter dated October 21, 2010 (the "October 21st Letter") in which it proposed alternatives to DMC being acquired by Vanguard. The alternative scenarios presented in the October 21st Letter included the idea of a possible acquisition of DMC by other non-profit health systems and DMC accessing the bond markets for additional capital in lieu of a merger or sale transaction. We reviewed the issues raised by the SEIU in their aforementioned letters and present our comments below.

SEIU ALLEGATION THAT THE PURCHASE PRICE IS TOO LOW

In the September and October 13th Letters which are focused on valuation, the SEIU alleges that the purchase price for DMC is too low. To support its position, the SEIU relies solely upon market transaction data points. We note that the SEIU did not perform a discounted cash flow ("DCF") analysis, a generally accepted valuation methodology, to support its assertion. A DCF

[1] Letter to Attorney General Mike Cox dated September 27, 2010, p. 3.
[2] Letter to Attorney General Mike Cox dated September 27, 2010, pp. 7 – 8.

analysis indicates the fair market value of a business or assets of a business based on the value of the cash flows that the business or the assets could be expected to generate in the future. A DCF analysis would reflect the actual expectations and unique financial attributes of DMC. In addition, it does not appear that the SEIU has met with DMC management to discuss DMC's projected financial performance.

In its letters, SEIU focuses on four sources of information which it feels supports its position that the purchase price for DMC is too low: data from Avondale Partners, data from Irving Levin & Associates ("Irving Levin"), the Caritas transaction, and previous Vanguard acquisitions.

SEIU Does Not Consider the Assumption of Pension and Malpractice Liabilities

The SEIU has assumed that the total purchase price for the DMC is $417 million. However this calculation does not take into consideration the pension and net malpractice liabilities (approximately $220 million[3,4] as of August 31, 2010) that Vanguard is assuming as part of the transaction. If the assumed liabilities were considered as part of the purchase price, the total consideration paid by VHS is $637 million, which is approximately 30% of DMC revenue.[5]

Avondale Report Issues

In its September Letter, the SEIU argues that Vanguard's cash offer of $417 million for the DMC is "extremely" low at only 20 percent of revenue (as noted above, the revenue multiple being paid for DMC is actually approximately 30% of revenue).[6] To support this assertion, they state that

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[3] The $220 million does not include the $12 million current portion of the malpractice liability. We conservatively treated the current portion of the malpractice liability as a working capital item as opposed to a long-term non-operating liability.

[4] The breakdown of the $220 million liability equals approximately $190 million in pension liability and $30 million in net malpractice liability per DMC financial statements as of August 31, 2010. DMC's actuary, Aon Hewitt estimates that the unfunded pension liability will increase to $293 million as of December 31, 2010. If this amount is added to the $30 million net malpractice liability, the total estimated pension and malpractice liabilities to be assumed by Vanguard as of December 31, 2010 equal approximately $323 million.

[5] The $637 million does not include the $500 million special project capital expenditure commitment that Vanguard is making as part of the transaction.

[6] Letter to Attorney General Mike Cox from the SEIU dated September 27, 2010, p. 3.

"recent deals have been priced at approximately 60 percent of revenue,"[7] and cite a January 2010 hospital industry report from Avondale Partners. We reviewed the Avondale report and observed the following:

- Avondale is an investment banking and sell-side equity research firm. The report cited by the SEIU is from a hospital sector analyst covering HMA, Tenet, Lifepoint, Community Health Systems and Universal Health Services. This focus appears to limit the scope of his report to hospital deals that are only relevant to the companies in his coverage universe versus a broader look at hospital M&A.

- The transaction multiple data by year is only based on three transactions in 2009 and two transactions in 2008. The multiples appear to be limited to acquisitions by large hospital systems in the Avondale coverage universe. Their analysis did not consider numerous private transactions that have occurred between 2007 and 2009.

- The methodologies used by Avondale to calculate the purchase prices for the various transactions are inconsistent. In some cases, the purchase price includes capital expenditure commitments (either the full value or the present value) and in some cases it does not.

Consideration of the Irving Levin Data

The October 13th Letter states that based on Irving Levin data, the average Price/Revenue multiple was 78% of revenue in 2009, which is almost four times the multiple of 20% of revenue in the proposed Vanguard – DMC transaction. According to the October 13th Letter, the median 2009 Price/Revenue multiple per Irving Levin is 77% of revenue. This median appears to be based on 13 transactions, with a range of revenue multiples of 27% of revenue to 130% of revenue.[8] Such a large range and limited data calls into question the appropriateness of relying on a median multiple for a single year as an indication of value. In addition, certain of the deals included in the 2009 median multiple are for the acquisition of hospitals that

[7] Letter to Attorney General Mike Cox from the SEIU dated September 27, 2010, p. 3.
[8] Irving Levin database. Does not include transactions that occurred in bankruptcy, as Irving Levin indicates that such transactions are not included in the mean and median.

are substantially more profitable than the DMC, which would make them less comparable.

The October 13th Letter also suggests that the multiple of EBITDA that Vanguard plans to pay for DMC is too low based on a comparison to data from Irving Levin. The median 2009 Price/EBITDA multiple as calculated by Irving Levin was 8.6x. However, as Irving Levin points out, it is challenging to use this multiple because of the lack of timely disclosure of financial information and the disinclination of buyers to reveal current EBITDA of their target hospitals.[9] Irving Levin also points out that because the buyer has more current financial data when making the offer, we have to assume that the Price/EBITDA multiples contained in its report are somewhat high as they are based on information that is one or two years old. In addition, historical performance is not necessarily indicative of future results. Buyers often price their acquisitions on pro forma EBITDA and will discount the historical performance if they believe it to be misleading.[10] In addition, the median multiple per Irving Levin appears to be based on only 8 transactions with a range of 4.4x to 19.5x. Such a large range and limited data further calls into question the reliability of the Price/EBITDA multiple data SEIU cites.

Caritas Transaction

The September Letter also discusses the pending transaction between Caritas Christi Healthcare and Cerberus Capital Management, stating that Cerberus will infuse "$430 - $450 million in cash immediately to extinguish Caritas debt, finance renovation, provide working capital and assume the system's pension liability. This amount translates into nearly 35 percent of Caritas' 2009 revenue.[11]" In order to make a more "apples to apples" comparison between the Caritas and DMC transactions, the liabilities that Vanguard will assume should be treated as deal consideration. If the $220 million[12] in

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[9] The Hospital M&A Market: Five-Year Report & Outlook, Second Edition, 2010.
[10] The Hospital M&A Market: Five-Year Report & Outlook, Second Edition, 2010.
[11] Letter to Attorney General Mike Cox from the SEIU dated September 27, 2010, p. 3.
[12] DMC's actuary, Aon Hewitt estimates that the unfunded pension liability will increase to $293 million as of December 31, 2010. If this amount is added to the $30 million net malpractice liability, the total estimated pension and malpractice liabilities to be assumed by Vanguard as of December 31, 2010 equal approximately $323 million. Using the $323 million figure, the implied revenue multiple for DMC would be even higher.

assumed pension and malpractice liabilities are added to the purchase price, the revenue multiple would be 30% of DMC's historical revenue, which is comparable to the Caritas multiple.[13]

The October 13th Letter indicates that the EBITDA multiple being paid for Caritas is 14.5x. This is inconsistent with information contained within the report of the Massachusetts Attorney General. According to the Massachusetts Attorney General's Report, Caritas' EBITDA is approximately $80 million to $85 million[14], which implies a Price/EBITDA multiple of approximately 6x. SEIU notes in the October 13th Letter that DMC's 2009 EBITDA was approximately $125 million; given this the implied multiple for the DMC transaction, taking into consideration the pension and malpractice liabilities being assumed by Vanguard, is approximately 5x. Accordingly, SEIU's statement that the median 2009 Price/EBITDA multiple of 8.6x based on Irving Levin data is "two and a half times the multiple Vanguard has offered for DMC" is inaccurate.

SEIU argues in the September Letter that DMC warrants a higher transaction value than Caritas because it is more financially stable. Specifically, it states "DMC has had a longer history of solid financial performance, whereas Caritas generated negative operating income in 2008…Surely DMC, a system that has "operated in the black since 2004" according to CEO Mike Duggan, warrants a higher transaction value."[15] Based on data contained in Medicare cost reports, we compared the historical financial performance of Caritas[16] and DMC and found that while Caritas performed poorly in 2008, its performance was only slightly below that of DMC between 2005 and 2007. In addition, Caritas' performance in 2009 is estimated to be higher than that of DMC. While DMC may have been "in the black" from a net income standpoint since 2004, it was not generating adequate cash flow to fund necessary capital expenditures. This is likely reflected in Moody's assessment of the two systems. Moody's rates Caritas as an investment grade

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[13] Further, Vanguard is committing to a significant capital expenditure commitment in the proposed DMC acquisition.
[14] Statement of the Attorney General as to the Caritas Christi Transaction, p. 22.
[15] Letter to Attorney General Mike Cox from the SEIU dated September 27, 2010, p. 4.
[16] Our analysis of Caritas' historical financial performance is based on data for the individual hospitals contained in Medicare Cost Reports. Caritas' consolidated financial statements are not publicly available and therefore we estimated corporate expenses for the system.

health system, at a rating of Baa2 which is four notches higher than that of speculative-grade rated DMC.

Comparison to Other Vanguard Transactions

The SEIU's October 13th Letter also indicates that Vanguard has paid higher multiples for other transactions in 2010. Vanguard purchased two Chicago area hospitals for a multiple of 20% of revenue and the Arizona Heart Institute for a 40% of revenue multiple. The SEIU argues that a higher multiple should be paid for DMC as the hospitals in Chicago and Arizona had experienced operating losses while DMC had not. The SEIU's comparison of these deals does not take into consideration 1) the assumption of $220 million[17] of non-operating liabilities to be assumed by Vanguard in the proposed transaction with DMC, and 2) Vanguard has committed to spend $850 million ($500 million in special project capital expenditures) over the next five years. In addition, our understanding is that a significant portion of the Chicago hospitals' underperformance was related to corporate overhead costs allocated from the prior parent. Furthermore, Vanguard's acquisition of the Arizona Heart Institute is expected to be synergistic for Vanguard given their other hospitals in the area, and Vanguard expects substantial improvements in margins and cash flow at the Arizona Heart Institute as a result of the acquisition.

ALLEGATION THAT THE CAPITAL SPENDING PLEDGE IS BELOW AVERAGE

In the September Letter, SEIU alleges that Vanguard's pledge to spend $850 million over five years is "below average."[18] To support this point, the SEIU calculates the average that Vanguard will spend per year ($170 million), and notes that this represents 8.1% of DMC's 2009 sales.[19] The SEIU alleges that this is lower than the weighted average of what Michigan's nonprofit hospitals spent as a % of revenue in 2009.[20]

[17] DMC's actuary, Aon Hewitt estimates that the unfunded pension liability will increase to $293 million as of December 31, 2010. If this amount is added to the $30 million net malpractice liability, the total estimated pension and malpractice liabilities to be assumed by Vanguard as of December 31, 2010 equal approximately $323 million.
[18] Letter to Attorney General Mike Cox from the SEIU dated September 27, 2010, p. 7.
[19] Letter to Attorney General Mike Cox from the SEIU dated September 27, 2010, pp. 7 – 8.
[20] Letter to Attorney General Mike Cox from the SEIU dated September 27, 2010, pp. 7 – 8.

The SEIU did not provide the underlying data to support its calculation, however there are issues with the data that is cited. First, the SEIU states that "Trinity Health System, based in Michigan spent $610.9 million in 2009 or 9.7% of its net revenue.[21]" Trinity Health System is a national health system with hospitals in California, Idaho, Indiana, Iowa, Maryland, Michigan and Ohio.[22] In addition, Trinity operates in both urban and non-urban areas. Accordingly, it is not necessarily an appropriate benchmark for the DMC. Also, the SEIU's use of data for only one year is misleading as Trinity spent only $446 million in capital expenditures (6.4% of revenue) for the fiscal year ended June 2010.[23] The SEIU should take this more recent data for Trinity into account or consider a longer period for its review. It is inappropriate to rely on only one year of data when conducting a benchmark analysis as spending levels can fluctuate significantly from year to year. The SEIU also cited Spectrum Health's 2009 capital spending level (8.3%), again only taking one year of data into account. In addition, the SEIU did not consider that Trinity and Spectrum are more profitable hospital systems than DMC and therefore have greater cash flow available for capital expenditures.

Failure to Consider DMC's Profitability in Connection with Capital Spending

The SEIU argues that even though Vanguard's planned capital spend of 8.1% of revenue is higher than what DMC spent in 2009, it is lower than the 9.2% weighted average for Michigan nonprofit hospitals. The SEIU does not perform any analysis of the profitability of the hospitals included in its benchmark relative to that of the DMC. Over the next five years, Vanguard plans to spend on average a greater percentage of revenue on capital expenditures than it projects it will earn in EBITDA (cash flow).

Failure to Consider DMC's Historical Levels of Capital Spending

In addition, the SEIU fails to point out that DMC spent only 3.1% of revenue on capital expenditures in 2009 and 3.3% on average between 2007 and 2009. Vanguard plans to spend substantially more than what DMC would be able to spend as a stand-alone entity.

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[21] Letter to Attorney General Mike Cox from the SEIU dated September 27, 2010, p. 8.
[22] Trinity Health Systems website.
[23] Trinity Health Systems financial statements for the fiscal year ended June 30, 2010.

SEIU'S ANALYSIS OF OTHER POTENTIAL ACQUIRERS

The SEIU's October 21st Letter states that in the Midwest region, there are "several examples of strong nonprofit systems with the necessary capital, capacity and infrastructure investments to acquire and operate DMC."[24] The SEIU further states that the nonprofit systems Ascension, Trinity and Catholic Health Initiatives ("CHI") have strong balance sheets, low leverage, and high liquidity, and therefore would be "well positioned" to acquire DMC.[25] The letter also states that "Ascension, CHI or Trinity would likely welcome the opportunity to gain such a strong foothold in a new market by acquiring a market leader."[26]

Parties Analyzed by SEIU Have Not Expressed Interest in Acquiring DMC

It does not appear that the SEIU has had contact with any of the parties nor has it performed any due diligence to gauge the potential interest of these parties in acquiring DMC. Further, we understand that Mike Duggan met with the CEO of Ascension in 2009 to discuss the possibility of a DMC/Ascension partnership.[27] Mr. Duggan indicated that he was told that Ascension would not have an interest and it would be unlikely that any other non-profit could partner with DMC because of DMC's poor balance sheet. Ascension was later contacted by DMC's financial advisors and again declined to pursue a transaction.[28] Four other parties were contacted regarding the opportunity to partner with DMC, all of whom declined.[29] In addition, DMC and Vanguard signed a letter of intent in March 2010, but did not finalize the Purchase and Sale Agreement until June 2010. During this period, it was public knowledge that DMC was looking for a strategic partner. If any of the parties identified by the SEIU had an interest in acquiring DMC, they likely would have contacted DMC during the three-month period prior to the consummation of the Purchase and Sale Agreement between DMC and Vanguard. According to DMC management, they

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[24] Letter from the SEIU dated October 21, 2010, p. 2.
[25] Letter from the SEIU dated October 21, 2010, p. 2.
[26] Letter from the SEIU dated October 21, 2010, p. 3.
[27] Based on conversations with DMC senior management.
[28] Based on conversations with DMC senior management.
[29] Based on conversations with DMC senior management.

received no indications of interest from other potential acquirers during this period.

SEIU Presents Misleading Financial Statistics

The SEIU's October 21st Letter presents the following leverage and liquidity statistics to support its position that Ascension, CHI and Trinity are in a better position to acquire DMC than Vanguard.

Entity	Long-Term Debt / Assets	Interest Coverage	Days Cash on Hand
DMC	38.9%	3.9x	15.2
Ascension	23.5%	11.2x	218.0
CHI	32.8%	7.3x	210.1
Trinity	27.4%	8.7x	232.5
Vanguard	63.9%	1.8x	32.1

There are issues with the calculations of the days cash on hand and interest coverage statistics in the SEIU letter (which are reproduced above), therefore the information presented is misleading.

Days Cash on Hand

Days cash on hand is calculated as follows:

Cash / ([operating expense – depreciation expense]/365)

The days cash on hand presented in the table above for Ascension, CHI, and Trinity is calculated inconsistently with the calculations presented for DMC and Vanguard. Specifically, the "Cash" for Ascension, CHI and Trinity includes not only cash and cash equivalents, but also investments and assets limited as to use. These assets include, but are not limited to, board-designated investments, restricted assets, and funds held in trust under bond agreements. These assets were not included in the calculation of days cash on hand for DMC. Vanguard, as a for-profit, does not have many of these categories of assets. Because the assets are designated for specific purposes, they may not be available to use for general operating purposes and thus should not be included in a days cash on hand calculation.

The table below presents the calculations for all entities on a consistent basis:

Entity	Days Cash on Hand – Includes Investments and Assets Limited as to Use	Days Cash on Hand – Excludes Investments and Assets Limited as to Use[30]
DMC	97.2	13.8
Ascension	218.0	31.4
CHI	210.1	22.0
Trinity	232.5	31.6
Vanguard	32.1	29.6

As shown above, if the assets limited as to use and other investments are excluded from the calculation of days cash on hand, the results for Ascension, CHI and Trinity are more in line with Vanguard. In addition, the SEIU notes in their letter that days cash on hand is "not commonly applied to for-profits because investor owned operators tend to keep enough cash to fund working capital needs and can access the equity or debt markets for additional capital."[31]

Interest Coverage

Interest coverage ratios are often calculated using the following formulas:

EBITDA[32] / Interest Expense

EBIT / Interest Expense

The SEIU's letter states that interest coverage measures a hospital system's ability to pay the interest that is due on its debt with its earnings before interest and taxes ("EBIT"). However, it appears that the interest coverage ratio is calculated using EBITDA. It also appears that in the calculations of EBITDA, non-recurring items have not been excluded. Credit agreements typically allow for one-time items to be excluded from EBITDA in the

[30] The amounts shown include only the line item "cash and cash equivalents" in the numerator of the calculation of days cash on hand.
[31] Letter from SEIU dated October 21, 2010, p. 2.
[32] EBITDA is defined as earnings before interest, taxes, depreciation and amortization.

calculation of interest coverage ratios. For example, if non-recurring items are excluded from EBITDA for Vanguard, the interest coverage ratio increases to 2.8x, as opposed to the 1.8x that SEIU calculates. Further, Vanguard's interest coverage ratio is expected to improve as a result of the additional EBITDA it will generate as a result of the acquisition of DMC.

SEIU's Statement Regarding Pension "Investment" is Misleading

The SEIU's letter states that DMC has made significant "investments" in its pension and infrastructure…These investments increase DMC's marketability to potential buyers.[33] This statement is misleading as DMC has a substantial unfunded pension liability, which potential buyers would view as a negative rather than a positive. DMC's pension liability was equal to approximately $190 million[34] as of August 2010 and is being assumed by Vanguard as part of the proposed transaction.

SEIU Assertion that the DMC Should Be Able to Issue Bond Debt

The SEIU's October 21st Letter encourages the Attorney General to urge DMC to access the bond markets in order to raise capital to fund DMC's expansion needs.[35] Based on discussions with DMC management, this does not appear to be a feasible option for DMC. In addition, we looked at other indicators of DMC's ability to issue bonds, including what credit analysts are saying. We discuss our findings below.

Speculative Credit Ratings and Recent Outlook Change

DMC unsuccessfully attempted to raise debt capital in 2008. At that time, DMC's rating from Standard and Poor's was speculative (BB-). DMC's credit rating remains at this same speculative grade rating today. In early October Standard & Poor's issued a report titled "Volatile Times Continue for Speculative-Grade Health Care Providers." In this report, S&P states "We expect that instability will continue to prevail in this category

[33] Letter from the SEIU dated October 21, 2010, p. 3.
[34] DMC's actuary, Aon Hewitt estimates that the unfunded pension liability will increase to $293 million as of December 31, 2010.
[35] Letter from the SEIU dated October 21, 2010, p. 4.

[speculative grade] of credits as organizations contend with ongoing economic and industry-wide hurdles, including softer volumes, potential state Medicaid funding or eligibility changes, high bad debt and charity care, capital needs related to IT investment, and physical plant upkeep. In addition, we believe that the Centers for Medicare and Medicaid Services (CMS) fiscal 2011 Medicare rates will likely result in lower total inpatient payments to acute care hospitals compared with fiscal 2010, which in our view will further burden providers. Moreover, we remain uncertain as to how the Patient Protection and Affordable Care Act will ultimately affect providers as many rules have yet to written, though we do believe that certain aspects will present additional credit risks in the medium to long term."[36]

In addition, on September 28, 2010, Moody's, which also has a speculative grade rating for DMC, cut its outlook for DMC to "negative." Moody's release stated "the outlook revision is attributable to our concerns with the difficult operating environment that is contributing to an inability to improve liquidity with anticipated sizable cash contributions needed in the near term to fund the large underfunded defined benefit pension liability and to support needed capital investment. With the decline in the Michigan economy that has led to declines in the population, especially in the metro-Detroit area, along with increased competitive pressure on the fringes of the service area from newly opened hospitals in the last two years, we believe increased pressure will be placed on volume metrics and revenue growth."[37]

The ratings agencies' views demonstrate that DMC is in a difficult financial situation. If DMC were to take on more debt, it would be even more highly levered and therefore potentially in a more precarious financial situation.

<u>Recent Nonprofit Bond Transactions</u>

The SEIU letter states that "Wall Street may now have an appetite for tax-exempt debt, as evidenced by the success that DMC's nonprofit peers experienced in raising debt this year".[38] To support this statement, the SEIU points to three bond transactions consummated by Henry Ford Health in 2009, MidMichigan Health in 2009, and Trinity in 2010. As shown below,

[36] "Volatile Times Continue for Speculative-Grade Health Care Providers", Standard & Poor's, October 4, 2010.
[37] Moody's Investor Service, September 28, 2010.
[38] Letter from the SEIU dated October 21, 2010, p. 4.

each of these entities have **investment** grade credit ratings, unlike the **speculative** grade rating of DMC.

S&P Rating	Grade
AAA AA A BBB	Investment Grade
BB B CCC CC C	Speculative Grade

Entity	S&P Rating
DMC	BB- Stable
Henry Ford	A Stable
Trinity	AA Stable
MidMichigan Health	A+ Stable

In contrast to Moody's placement of DMC on "negative" outlook, the credit ratings for Henry Ford and Trinity were re-affirmed in September 2010 and October 2010, respectively. In addition, S&P points out in a recent report that there is a notable distinction in credit quality between investment-grade and speculative grade credits. [39] S&P also points out that they "understand that it is difficult for many speculative-grade providers to access the traditional tax-exempt debt markets, so they are more likely to seek more expensive or restrictive financing, such as federally insured debt, capital leases and bank loans. [40]

Given DMC's speculative grade rating and the commentary above from the ratings agencies, it seems that it may be difficult for DMC to successfully access the tax-exempt bond market.

[39] Volatile Times Continue for Speculative-Grade Health Care Providers", Standard & Poor's, October 4, 2010.
[40] Volatile Times Continue for Speculative-Grade Health Care Providers", Standard & Poor's, October 4, 2010.

The limiting conditions contained in our report to the Michigan Attorney General dated November 11, 2010 would also apply to this memorandum.

Yours very truly,

ALIXPARTNERS, LLP