



Portneuf Medical Center Financing Assessment

Requested by the
Bannock County Board of Commissioners
January 14 and 15, 2008

STROUDWATER ASSOCIATES

Stroudwater's Charge

Stroudwater has been retained by the Bannock County Commissioners to provide an objective analysis of PMC's ability to implement the East Campus consolidation project as a stand alone facility.

Specific areas of investigation include:

- Analysis of PMC operating performance
- Comparison of PMC actual operating performance to targeted operating performance
- Assessment of PMC operating performance relative to 2007 S&P Median Ratios for Stand-Alone Hospitals
- Debt capacity analysis and recent rating agency actions
- Analysis of PMC's capital plan and its associated assumptions
- Stroudwater projection to define required PMC performance levels needed to make the capital plan feasible

Taken together, the results of the above analyses will provide decision-makers with information to assess the risk of PMC's strategy and the East Campus projects.

Overview of PMC's Strategy

- 2002 combination of Bannock Regional Medical Center and Pocatello Regional Medical Center
- Post-affiliation, stabilize operations and generate additional operating cash flows (EBIDA) to boost liquidity, enhance debt capacity and fund development of new consolidated campus
- 2005 purchase of land adjacent to east campus to position PMC for future operational and campus consolidation
- Planned phased development of east campus with eventual relocation and consolidation occurring over 8-10 years
- Utilize cash from operations, new debt issuance, developer financing and philanthropy to fund facility investments of \$200M+ and medical staff development
- Create a referral center for the region with consolidated operations at a new facility on the east campus

Source: S&P Ratings Direct, Portneuf Medical Center, December 21, 2007.

Operational Implications of PMC's Strategy

PMC's strategy requires improved operating performance above historic levels to provide adequate operating cash flows to:

- Build liquidity to provide a cushion for unexpected events as well as PMC equity contributions toward future project costs;
- Build debt capacity needed to fund the East Campus Project;
- Support the credit worthiness of PMC to maintain cost of capital consistent with the capital plan;
- Provide the financial resources needed to recruit new primary care and specialty physicians to the service area, and;
- Avoid the operating risks and exposure to construction inflation associated with delays in executing the East Campus projects

Operational Implications of PMC's Strategy, Continued

The operational efficiencies to be realized by consolidating at a single new acute care campus are not realized until the conclusion of the final phase of PMC's plan.

- As a result, the benefits of the consolidation strategy are not realized until the conclusion of the final phase.

If PMC falls short of the operating performance needed to fund the East Campus project, there is a cascading effect that reduces liquidity, decreases debt capacity, increases costs of capital and heightens the overall risks and project costs for the East Campus.

PMC Capital Plan

East Campus Project Plan of Finance: Sources and Uses

Sources:

Proceeds from Bond Issues:	\$179M
<i>Other: Asset Sales and/or Developers</i>	<i>TBD</i>
Philanthropy	<u>\$6M</u>
Total Sources	\$185M

Uses:

East Campus Project Costs:	\$200M
<i>Additional FFE Costs (Project Cost Schedule):</i>	<i>\$7M</i>
<i>Medical Staff Dev. Costs (Stroudwater estimate):</i>	<i>\$10M</i>
<i>Construction Inflation (@ 3.5%) from 1 Yr Delay:</i>	<u><i>\$7M</i></u>
Revised Total Project Costs:	\$224M

Sources: Wachovia Plan of Finance and PMC Capital Plan; PMC Environmental Scan; East Campus Project Cost and Phasing Plan.

East Campus Project Plan of Finance: Timing

The timing and par amounts of planned bond issues for the three most recent iterations of the PMC Capital Plan are provided below.

The most important revisions from the 7/12/07 plan is that the plan of finance for the East Campus project is now:

- Front loaded with \$70M to \$71M of debt issuance in CY 2008
- Not expected to be closed until CY 2013 rather than CY 2012

	Series 2008	Series 2009	Series 2011	Series 2012	Series 2013	Total Par Amount
7/12/07 Capital Plan	\$28.0M	\$102.8M	\$53.9M	\$8.3M	--	\$192.9M
7/31/07 Capital Plan	\$69.6M	--	\$100.1M	--	\$28.0M	\$197.7M
1/08/08 Capital Plan	\$70.9M	--	\$101.8M	--	\$28.7M	\$201.4M

It is notable that the above capital plans are not currently feasible because PMC's poor FY 2007 results and the recent downgrade of PMC by S&P would preclude issuing \$70M of debt in CY 2008.

Based upon debt service coverage medians at speculative grade credit, PMC has an estimated \$2M of net debt capacity currently.

Net debt capacity at the "BBB-" median is negative – (\$15M).

East Campus Project Construction Phasing

To successfully execute the East Campus project, PMC must coordinate:

- Operational performance to ensure access to capital as scheduled
- Project phases are conceived to provide downstream ROI to fund future phases
- Project and construction risk associated with a large, multi-phased capital project such as the East Campus

Year	Financing	Major Construction Phase	Construction Duration	Construction Cost
2008	\$70.9M	Site work; MOB; roads & parking; energy plant	15-19 mos	\$29M
2009	--	Hospital Bed Tower: Phase B	30 mos	\$105M
2010	--			
2011	\$101.8M	Hospital Bed Tower: Phase C	21 mos	\$54M
2012	--			
2013	\$28.7M	Existing Hospital: Phase D & Misc.	8 mos	\$14M

PMC Medical Staff Development Requirements

PMC's Capital Plan does not include any provisions for the costs of medical staff development.

PMC's Environmental Scan 2006 to 2011 defines current medical staff development needs for FY 2007 through FY 2009 to include:

- 9 to 12 primary care physician FTEs
- 23 to 33 specialty physician FTEs

PMC's Environmental Scan states that: ***“Physician recruitment is becoming much more difficult as the market becomes more competitive for candidates and as such recruitment is more expensive.”***

The market for physicians is evolving rapidly. Increasingly, physicians are seeking employment opportunities and as a result hospitals are increasingly employing physicians to recruit, retain and align with physicians.

Given the above scope of medical staff development need from FY 2007 through FY 2009 – and ongoing needs through then end of the projection period in 2018 – significant medical staff development costs should be included in any PMC projection for the East Campus Project.

Key Findings from Capital Plan Assessment

The \$200M project cost estimate for the East Campus Project does not include provisions for:

- \$7M in FFE costs are not included; all FFE costs not inflated
- \$7M in construction inflation from delays due to FY 2007 results
- An estimated \$10M in medical staff development related costs

Other areas of concern in the PMC Capital Plan include:

- By 2018, staffing ratios are projected to decrease from 6.45 to 6.00 FTEs per adjusted acute occupied bed vs. FY 2007 experience of 6.57.
- PMC's cost of capital assumed in the capital plan is too low given current market conditions and current PMC credit ratings.
- PMC's plan assumes a higher growth rate in admissions (1.1% CAGR) that is almost double the market share and growth weighted rate of increase in PMC's service area (0.6% CAGR).
- Bad debt is projected to remain flat as a percentage of gross revenue vs. recent experience of 10.5% increases (as a percentage of gross revenue) since FY 2004.

PMC Historical Operating and Financial Results

Comparison of Unaudited PMC Operating Results to S&P Medians

Based upon unaudited FYE 2007 results, PMC has fallen further below investment grade credit benchmarks on a stand alone basis before any additional indebtedness is incurred.

PMC's underperforms key 2007 S&P "BBB-" medians for profitability, liquidity and leverage. In December, S&P downgraded PMC two notches to "BB" based upon FY 2007 performance ***before any new debt issuance related to the East Campus project.***

Moody's affirmation of PMC's "Baa2" rating was based on preliminary 11 months results for FY 2007, which proved optimistic given actual PMC FYE 2007(unaudited) results.

	2007 S&P "BBB-" Median	PMC FY 2007 Unaudited	PMC FY 2006 Audited	PMC FY 2005 Audited	PMC FY 2004 Audited
Debt Service Coverage	2.7x	1.8x	2.4x	2.7x	2.0x
EBIDA Margin	11.2%	6.8%	9.0%	9.4%	7.0%
Days Cash on Hand	121	75	55	80	76

Sources: PMC unaudited FYE 2007 Financial Statements and 2007 S&P Medians for Stand Alone Hospitals.

Projected Admissions Growth for PMC

An accurate picture of PMC's future volumes needs to reflect two key factors:

- Where discharge growth will originate (driven by pop growth and ageing)
- PMC's market share in areas generating discharge growth (a proxy for the likelihood these new discharges will go to PMC)

	'06 to '11 Proj. Dischg Growth	Share of Total Dischg Growth	PMC Medicare Mkt Share	Est. PMC Growth in Dischgs	PMC Share of Proj. Dischg Growth
PSA	199	7%	80%	160	80%
SSA	488	17%	20%	99	20%
TSA	2,175	76%	<5%	109	<5%
AVG/Total	2,862		24%	367	13%

93% of discharge growth is projected to occur in PMC's SSA and TSA, where PMC had 20.3% and <5% 2006 Medicare market share, respectively.

-In contrast, while PMC had 80.3% market share in its PSA, this market segment will generate only 7% of projected admissions growth between 2006 and 2011.

Stroudwater has developed a projection based upon these parameters that indicates a 0.6% CAGR growth rate before any growth in market share.

PMC FY 2007 Service Volumes

As measured by adjusted acute days, FY 2007 patient service volumes at PMC were less than 90% of budgeted levels for each month of FY07.

Service volumes dropped below 80% of target levels starting in May 2007 and stayed there (excepting July at 82% of budget).

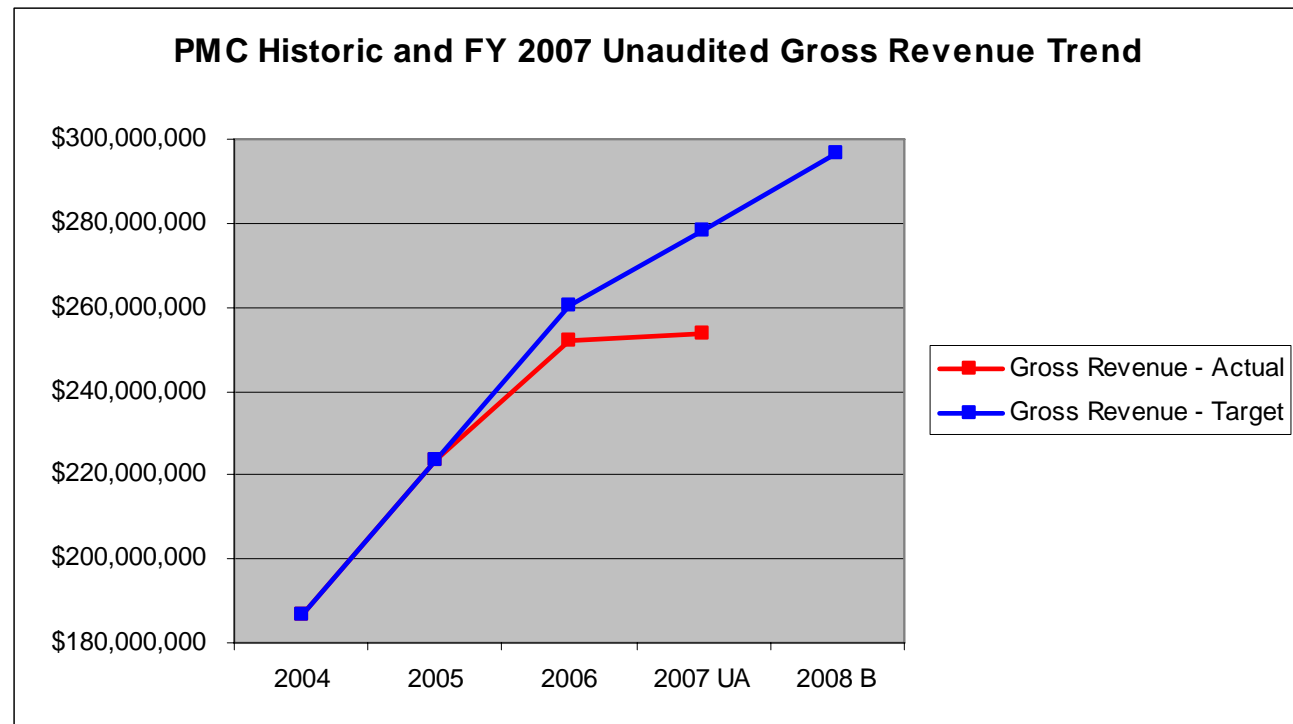
This 10%+ variance from targeted levels during each months of FY 2007 was a major contributing factor to PMC's FY 2007 results.

PMC's FY 2007 results were not the product of a single bad month but reflected a consistent variance from targeted levels.

PMC Target Performance: Gross Revenue

FY 2007 unaudited performance indicates that PMC generated almost \$25M less in gross revenue than the budget achievement plan target of \$278.3M for the fiscal year.

The YTD FY 2007 shortfall comes on the heels of an \$8M gross revenue shortfall in FY 2006.



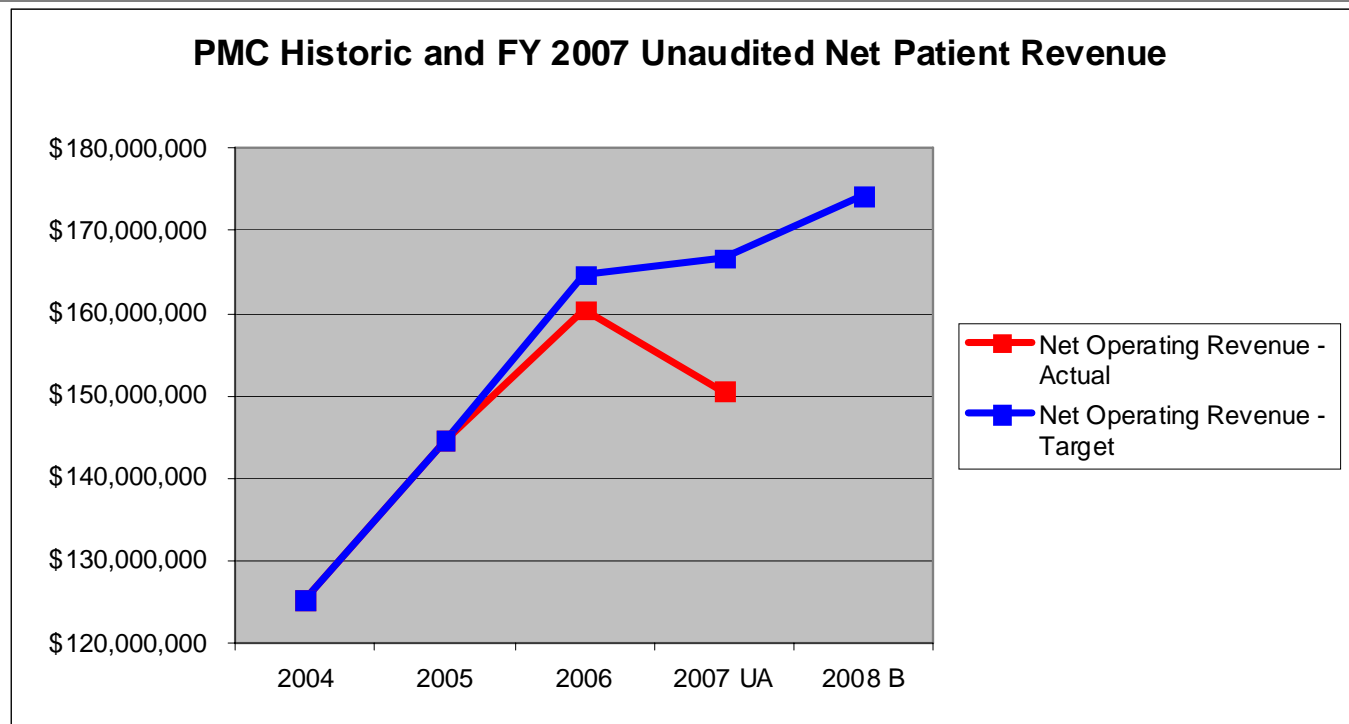
Source: PMC Financial Statement Executive Summary and Capital Plan dated July 2007 and PMC unaudited FY 2007 financials.

PMC Target Performance: Net Operating Revenue

Unaudited FY 2007 results indicate that net operating revenue was down \$16.2M or 9.7% below the targeted level of \$166.7M.

For FY 2006, PMC's net operating revenue was 2.6% below targeted levels.

YTD FY 2008 net operating revenue (based upon two months data) is 7.25% less than budgeted levels but 3.1% above prior year YTD results.



Source: PMC Financial Statement Executive Summary and Capital Plan dated July 2007 and PMC unaudited FY 2007 financials.

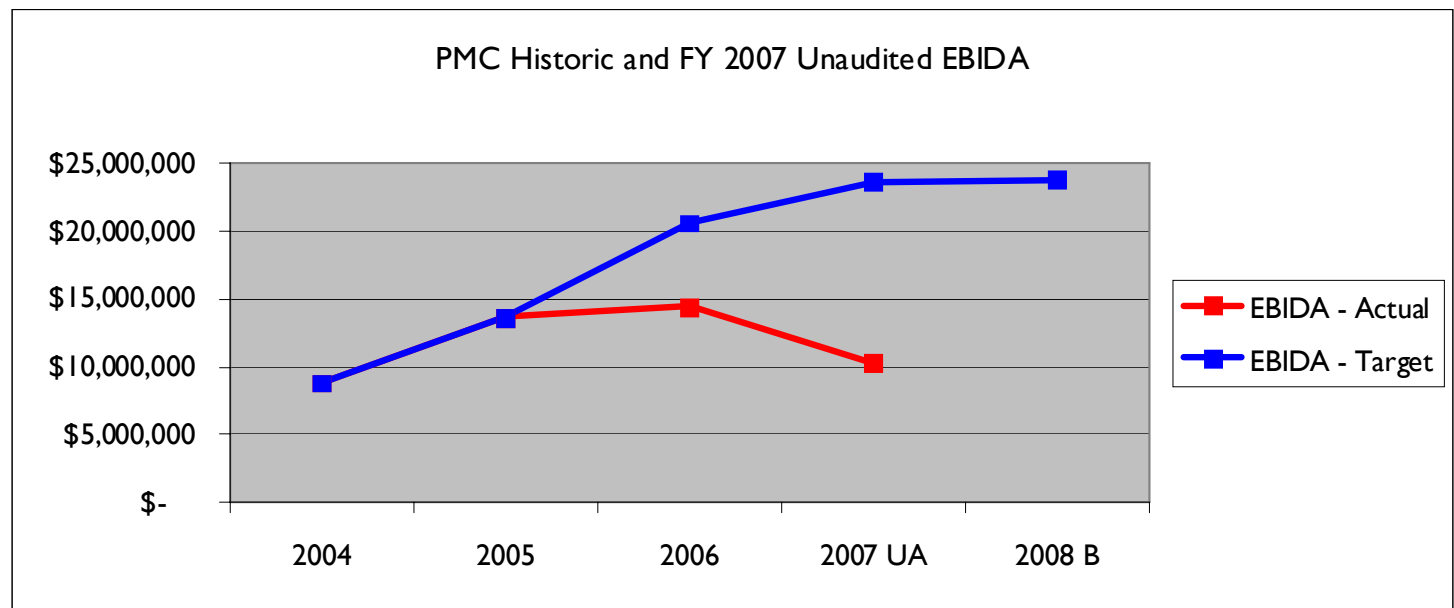
PMC Target Performance: EBIDA

Remaining project costs for the East Campus project are estimated at \$200M. PMC's current Capital Plan assumes that most of the funds required to underwrite the project's costs will come from three bond issues.

EBIDA provides a yardstick to assess an organization's ability to cover existing and future debt service obligations.

PMC's FYE 2007 EBIDA of \$10.3M is \$13.3M or 56% below targeted levels.

PMC's FY 2006 EBIDA was \$6.2M or 30% below budgeted levels.



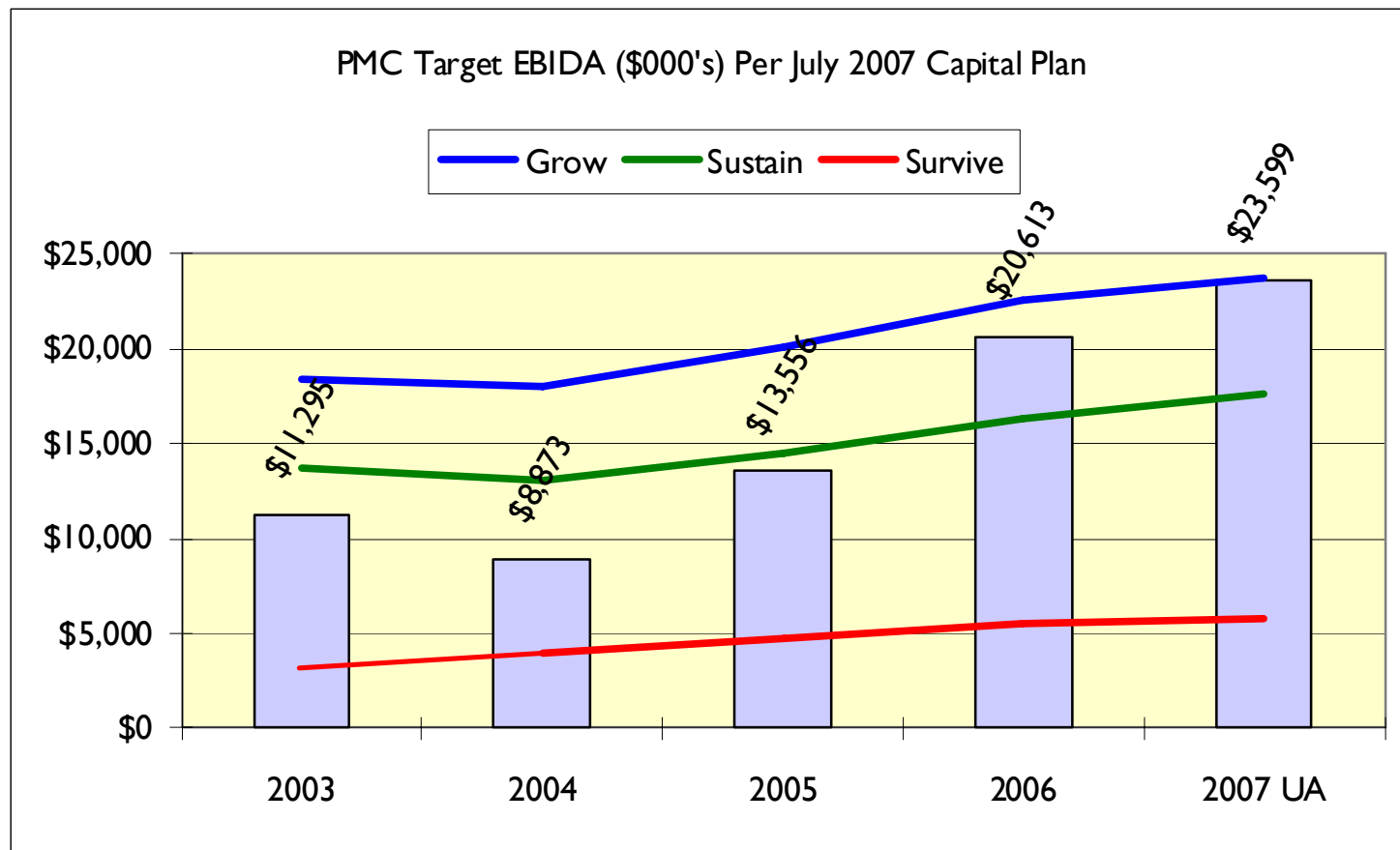
Source: PMC Financial Statement Executive Summary and Capital Plan dated July 2007 and PMC unaudited FY 2007 financials.

PMC Operating Performance Trajectory (Targeted)

PMC's *targeted* results in the July 2007 Capital Plan would support phased development of the East Campus.

The targeted levels of performance are consistent with the operational results needed fund major capital investments, such as the East Campus.

However, *actual* FY 2007 performance fell far short of targeted levels.



Grow = Debt Service + 1.2 X Depreciation + 4.0% of Op Expense

Sustain = Debt Service + 1.2 X Depreciation

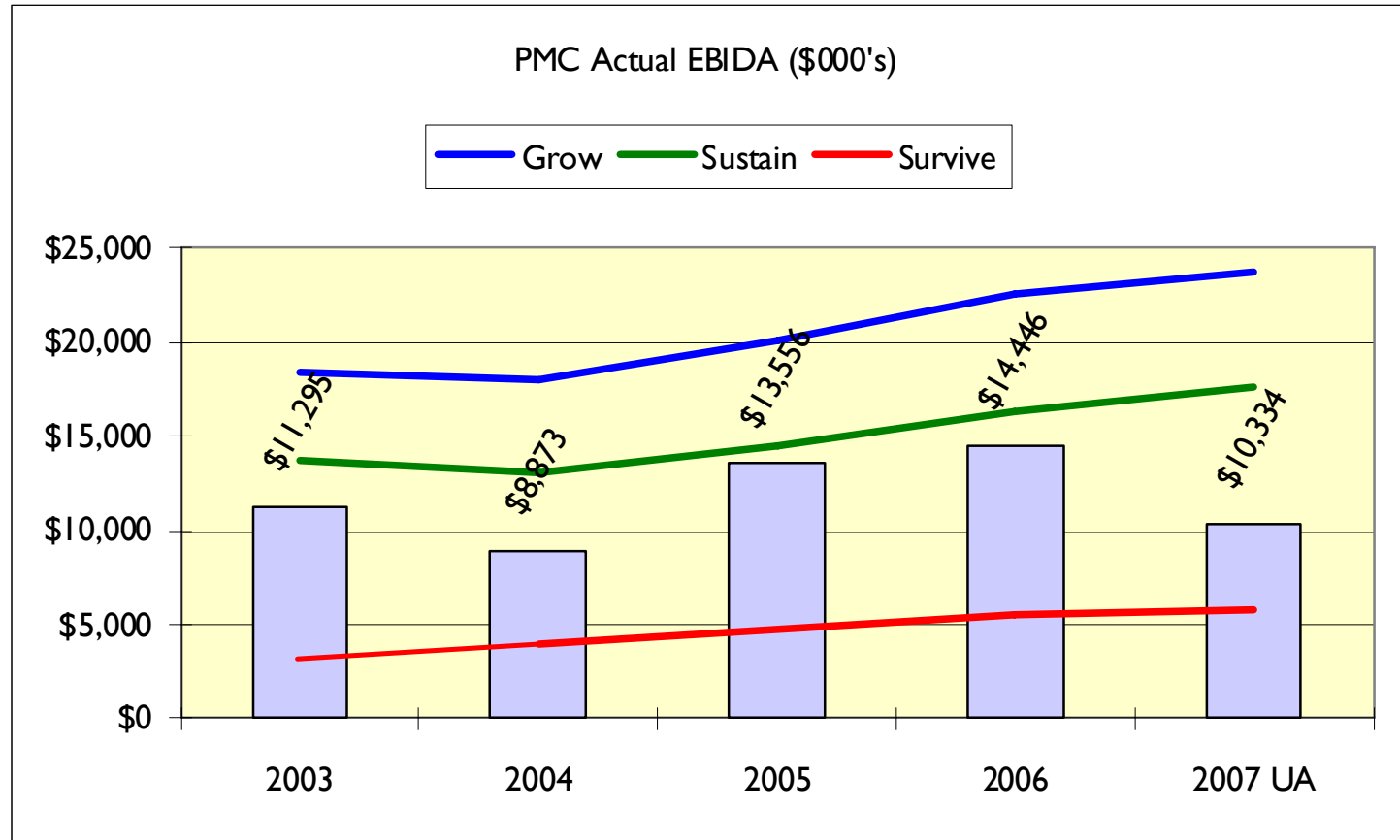
Survive = Debt Service

PMC Operating Performance Trajectory (Actual)

Unfortunately, PMC has not been able to achieve operating results necessary to achieve the “growth” threshold.

The variance between PMC’s actual operating results and targeted performance levels has widened since FY 2006.

For instance, FYE 2006 results were 30% short of targeted levels while FY 2007 results were 56% less than targeted.



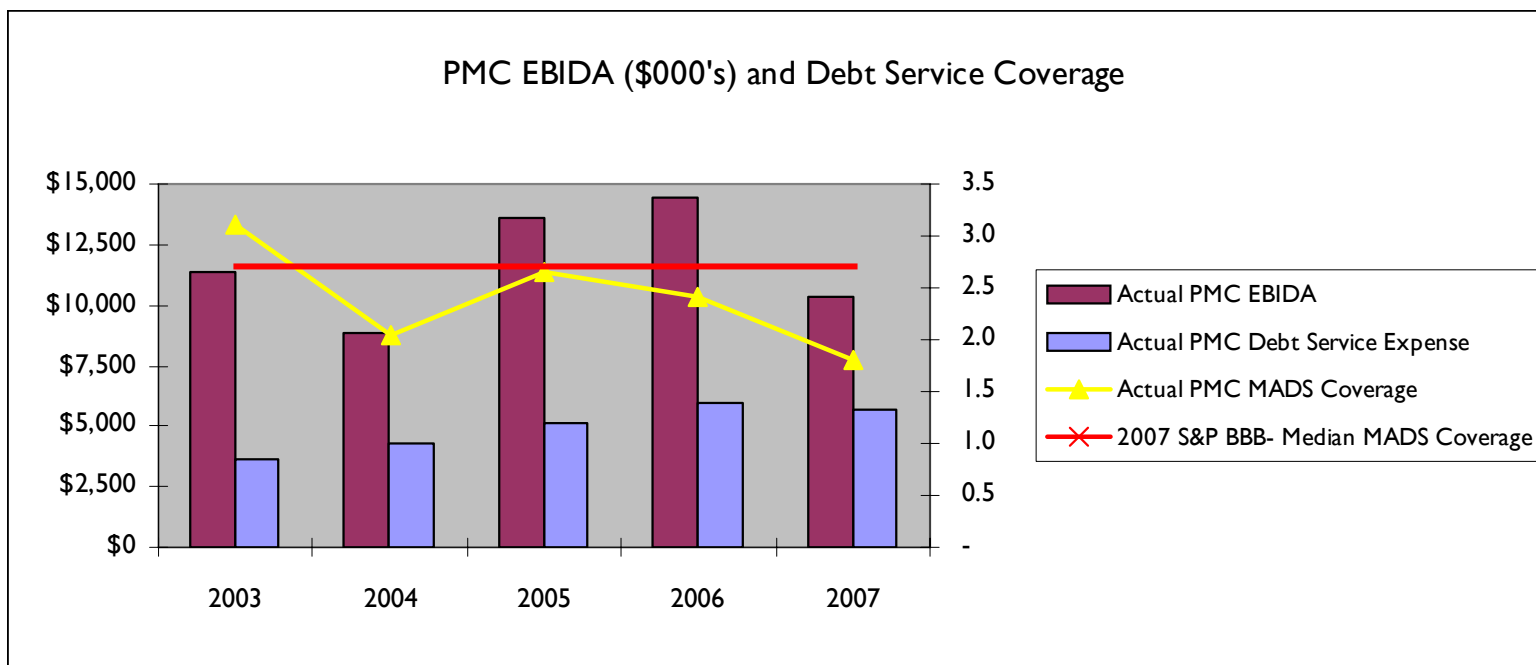
Unless other sources of capital are found, PMC needs to achieve EBIDA performance consistent with the “growth threshold” depicted above. Results consistent with the growth threshold in FY 2006 and FY 2007 would have greatly enhanced the feasibility of the East Campus Project.

PMC Historical and Current Financial Performance

While PMC's EBIDA (operating cash flows available for debt service expense) has remained relatively stable since FY 2003, PMC's debt service expense has increased.

The result is a 42% decline in PMC's debt service coverage ratio.

An organization's debt service coverage ratio is a key measure of its ability to incur additional indebtedness.



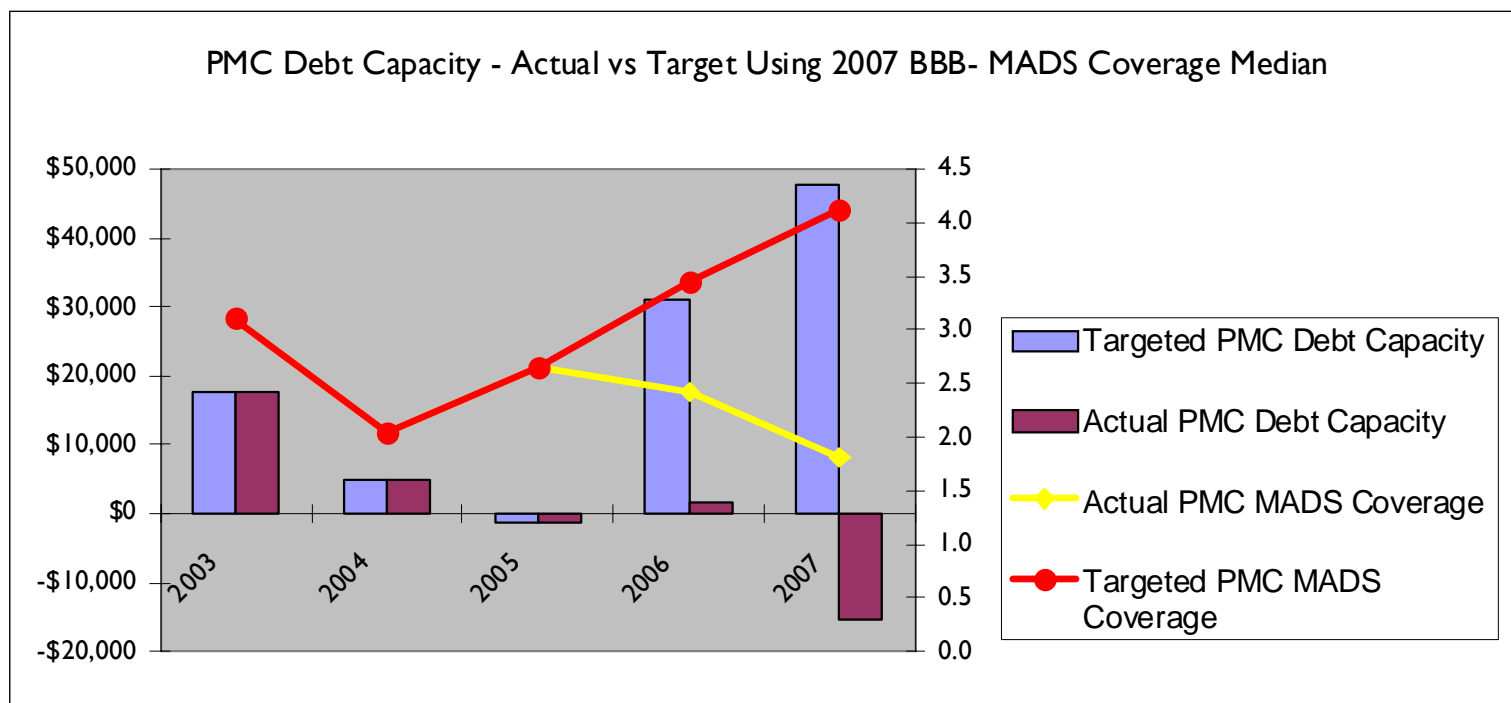
Financial Metric	2003	2004	2005	2006	2007	CAGR (%)
Actual PMC EBIDA (\$000's)	11,339	8,832	13,626	14,446	10,334	(2.3)
Actual PMC Debt Service Expense (\$000's)	<u>3,655</u>	<u>4,331</u>	<u>5,128</u>	<u>5,977</u>	<u>5,728</u>	11.9
Actual PMC MADS Coverage (x)	3.1	2.0	2.7	2.4	1.8	(12.7)

PMC Historical and Current Performance, Continued

The chart below contrasts PMC's historical debt service coverage ratio with targeted performance.

Using the S&P 2007 "BBB-" Median for stand-alone hospitals, estimates of PMC's targeted and actual net available debt capacity can be calculated for FY 2003 through FY 2007.

PMC's operating results in FY 2006 and FY 2007 were at a significant negative variance from targeted levels, 30% and 56% respectively.



Estimated PMC Debt Capacity

PMC's FY 2006 debt capacity ranges from \$2M to \$88M, depending upon the target credit profile and debt instrument employed.

However, FYE 2007 unaudited results sharply decreased PMC's debt capacity.

Based upon FY 2007 results, PMC's debt capacity is \$63M to \$142M below where it would be had PMC achieved targeted operating results.

PMC Debt Capacity Analysis

25-Year Average Maturity

PMC FY 2006 Cash Flow Available for Debt Service Coverage	\$	14.4	MM
PMC FY 2007 Unaudited Cash Flow for Debt Service Coverage	\$	10.3	MM
PMC FY 2007 Target Cash Flow for Debt Service Coverage	\$	23.6	MM

Assumed Interest Rates

	<u>"BBB-" Rated</u>	<u>Speculative</u>	<u>HUD 242</u>
25 -Year Bond Yield	6.00%	6.50%	5.50%
Debt Service Constant (25 Year Avg Maturity)	0.0782	0.0820	0.0745

PMC FY 2006 Estimated Debt Capacity

	<u>"BBB-" Rated</u>	<u>Speculative</u>	<u>HUD 242</u>
	<u>Median</u>	<u>Median</u>	<u>Median</u>
S&P 2007 Median MADS Coverage Ratio (x)	2.7	1.9	1.25
PMC Net Debt Capacity per MADS Coverage Median (MM)*	\$ 1.8	\$ 26.1	\$ 88.4

PMC FY 2007 (unaudited) Estimated Debt Capacity

	<u>"BBB-" Rated</u>	<u>Speculative</u>	<u>HUD 242</u>
	<u>Median</u>	<u>Median</u>	<u>Median</u>
S&P 2007 Median MADS Coverage Ratio (x)	2.7	1.9	1.25
PMC Net Debt Capacity per MADS Coverage Median (MM)**	\$ (15.2)	\$ 2.2	\$ 46.7

PMC FY 2007 Target Debt Capacity***

	<u>"BBB-" Rated</u>	<u>Speculative</u>	<u>HUD 242</u>
	<u>Median</u>	<u>Median</u>	<u>Median</u>
S&P 2007 Median MADS Coverage Ratio (x)	2.7	1.9	1.25
PMC Net Debt Capacity per MADS Coverage Median (MM)**	\$ 47.6	\$ 87.3	\$ 189.1

Notes: *Incremental debt capacity based upon \$66.6M in outstanding LT obligations.

**Incremental debt capacity based upon \$64M in outstanding LT obligations and unaudited FY 2007 results..

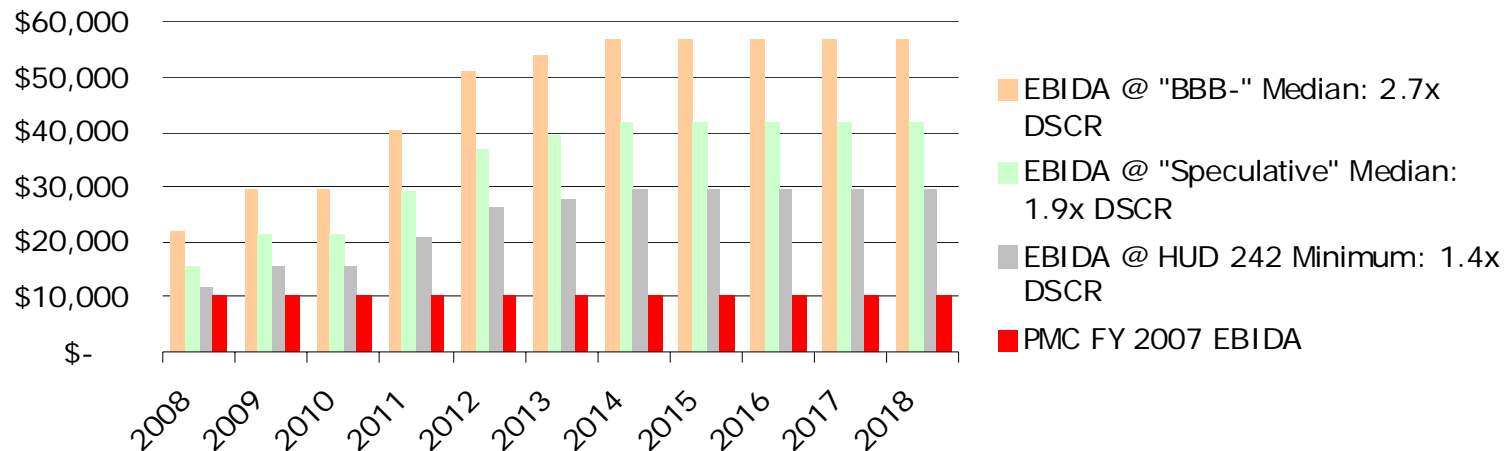
***Based upon targeted financial performance as of 8/31/2007 PMC Financial Statement Executive Summary.

PMC Financial Projection: EBIDA Requirements

Meeting debt service coverage ratio (DSCR) requirements associated with the issuance of \$201M of debt will require PMC to generate:

- 550% of FY 2007 EBIDA by 2014 to meet the minimum ("BBB-") investment grade DSCR median of 2.7x
- 400% of FY 2007 EBIDA by 2014 to meet the speculative grade DSCR median of 1.9x
- 285% of FY 2007 EBIDA by 2014 to meet minimum HUD 242 DSCR guidelines

Projected EBIDA Required to Fund PMC's East Campus Project (000's)



Recent Ratings Agency Actions

On October 5, 2007 Moody's affirmed PMC's rating of Baa2 with negative outlook based upon 11 months annualized results

On December 21, 2007, S&P lowered PMC's rating two notches from "BBB-" (investment grade) to "BB" (speculative) with a stable outlook based upon 12 months unaudited results

Both ratings agencies cited PMC's dominant market position and the potential for operating efficiencies via consolidation as strengths.

However, PMC faces several challenges, including

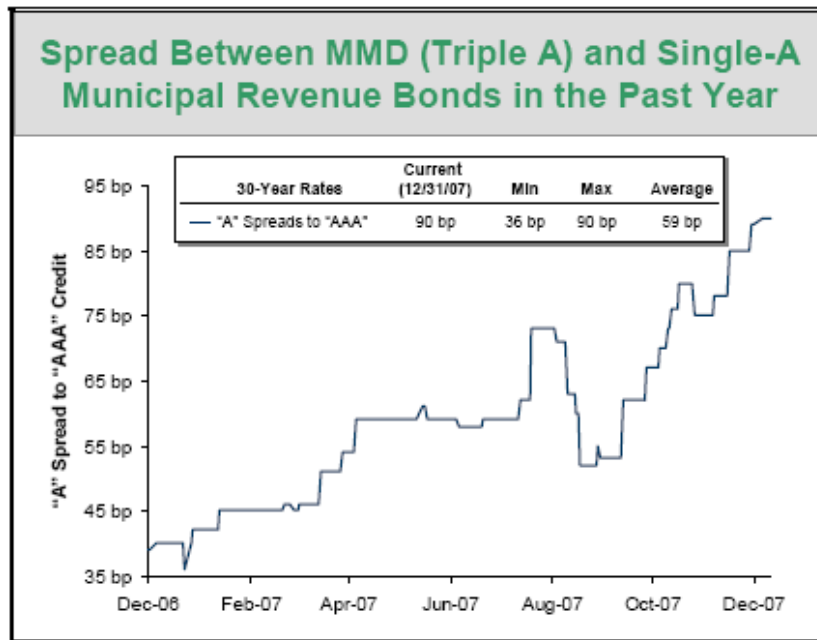
- Modest liquidity position with 61 days cash on hand
- A drop in revenue and an operating loss in FY 2007
- Weak debt service coverage of less than 2.0x
- Considerable capital needs going forward, which will likely be funded in part by additional debt, thereby further straining the balance sheet

Implications of S&P Downgrade for PMC

Credit spreads have widened over the course of 2007. As a result, non-investment grade credits such as PMC will face much higher borrowing costs in the near term.

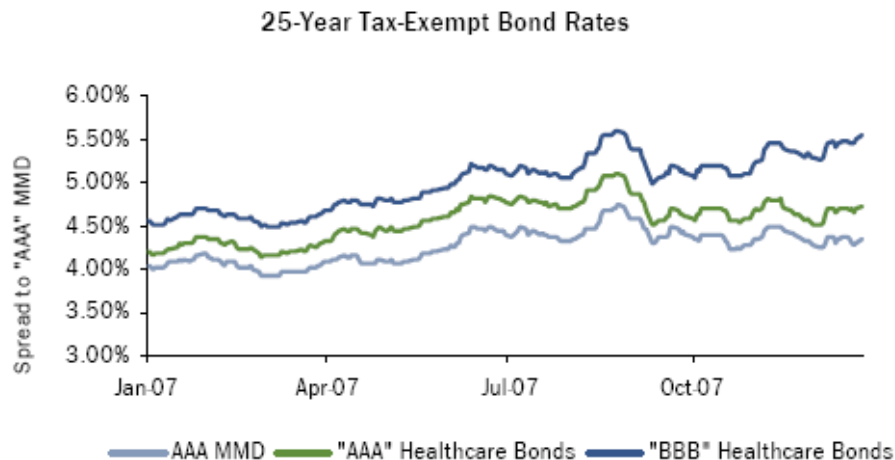
Overall, municipal bond yields remain attractive against historical norms.

However, the capital costs contained in PMC's Capital Plan are too low for a "BB" credit.



The spread between AAA and A rated municipal bonds in 2007 ranged from a low of 36 bp to a high of 90 bp. Credit spreads widened as the year progressed.

Source: Goldman Sachs.



During 2007, the cost of borrowing for "AAA" rated not-for-profit hospitals increased by 0.5% while the cost of capital for "BBB" rated not for profit hospitals increased by 20% from 4.50% to 5.50%. Borrowing costs for non-rated entities have risen even more dramatically.

Source: Wachovia.

Key Findings from PMC's Operating Results

“The critical component to (the PMC Capital Plan scenarios) is PMC realizing actual results close to those we projected.” - AG Edwards, 7/31/07

The 56% variance between targeted and actual operating performance (as measured by EBIDA) significantly decreased PMC's debt capacity while increasing the potential cost of capital for the East Campus project

The S&P downgrade from “BBB-” to “BB”, based upon full-year FY 2007 results, could increase PMC's cost of capital by approx. 100 bps from the costs assumed in the capital plan. ***For every \$10M of debt issuance, the downgrade translates into additional interest expense of \$75k (\$1.5M annually for \$200M in borrowing), assuming a 25 year amortization schedule.***

It is important to note that the S&P downgrade occurred before any additional debt for the East Campus project has been issued and calls into question the ability of PMC to issue additional debt.

Key Findings from PMC's Operating Results, Continued

PMC's FY 2007 operating results reveal several related trends at odds with key assumptions in the Capital Plan:

- Adjusted patient days were more than 10% less than targeted levels in each month of FY 2007 - down nearly 18% from budget for the year and 6.2% less than FY 2006 levels;

S&P's downgrade of PMC identified only a single one-time, non-recurring event impacting excess margin (\$2.1M loss from demolition) as a mitigating factor. No other year-end adjustments by PMC were identified as extenuating factors for PMC's FYE 2007 results.

As a result of FYE 2007 operating results, PMC plans to delay raising capital for the East Campus project. Assuming construction inflation of 3.5%, East Campus project costs will increase by \$7M on the remaining \$200M of project costs for each year of delay.

In addition, the delay means that the operating efficiencies derived from the East Campus consolidation project are pushed back further into the future.

Key Findings from PMC's Operating Results, Continued

PMC has consistently missed targeted operating performance in 2006 and 2007. Actual performance has declined from 2006 to 2007 and has been relatively consistent for the last 5 years, in spite of efforts to improve performance substantially

Due to declining performance and the risk associated with additional debt, the hospital's rating has been downgraded below investment grade, further hampering the hospital's ability to raise additional debt.

It is unlikely that without significant and sustained improvement in operating performance PMC will be able to finance the completion of the East Campus project on the schedule now contemplated.

A key benefit of the merger was the operating savings that could be realized through consolidation of services. Those savings will not be fully realized until the East Campus is completed and operations are consolidated on that campus.

Stroudwater Assessment of East Campus Project Feasibility

PMC does not have the ability today, based on current performance and ratings, to finance the East Campus project via traditional tax-exempt bond financing.

The ability to finance the East Campus project independently will depend on a significant improvement in operations and cash flow. Unfortunately, such results have not been achieved in the first two years of the performance improvement plan.

It is not uncommon for a large, complex capital project to encounter conditions that require revisions to the original plans and implementation strategy.

However, the fundamental strength of PMC's dominant market position, new tertiary programs and a compelling vision to become a regional referral center provides a basis for progress going forward.

The opportunity going forward is for PMC, the citizens of Bannock County and the Bannock County Commissioner's to collaboratively discuss, evaluate and choose one of several options for insuring that the East Campus Project becomes a reality.