Rationale for Acquisition of St. Paul and Zale Lipshy University Hospitals

UT Southwestern
Medical Center

Presentation to Regents
May 12, 2004

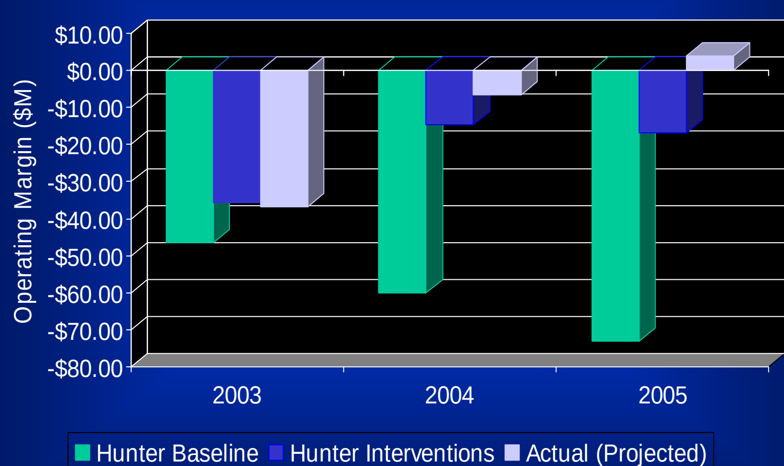
History of the UTSW-University Hospital Relationship

- Growth of the UTSW private-referral practice in the 1980s creates the need for a university hospital
- Zale Lipshy University Hospital is created as a separate 501(c)(3) corporation to "serve the needs of UT Southwestern."
- In 1998-1999, Zale Lipshy is at capacity and a 4-story expansion plan is developed.
- Following the request of key St. Paul physician leaders for UTSW to "buy and manage" St. Paul, UTSW purchases the real estate and equipment of St. Paul and leases the hospital entity to Zale Lipshy University Medical Center, Inc. to manage in December 2000.
- St. Paul viewed as a superior long-term option for expansion of the UTSW patient-care mission; Zale Lipshy expansion more expensive and limited in terms of future growth.

UT Southwestern Hospital Management Agreement

- UT Southwestern was asked by the board of the hospital holding company (University Medical Center, Inc) to provide the senior management for Zale Lipshy University Hospital and St. Paul University Hospital in April 2003.
- Goals: Integration of patient care services (inpatient and outpatient); management to facilitate financial turnaround of the hospitals.
- May 2004: Zale Lipshy profitable; St. Paul nearing profitability.
- Campus hospitals affiliated but not owned or managed by UT Southwestern:
  - -- Parkland Memorial Hospital
  - -- Children's Medical Center

UMC Financial Projections



Ongoing UMC Challenges

- Despite projected positive operating margin, UMC will not be able to fully support the long-term vision of UTSW
- Shift toward minimally-invasive, outpatient care
- Inability to transfer funds between Zale Lipshy and St. Paul
- Malpractice costs
- Access to capital
  -- Even with operations corrected, the balance sheet will have inadequate assets for any substantial debt capacity; the hospitals alone are not credit worthy
- Conflicts of interest and purpose at St. Paul
  -- The fiduciary responsibility of the Board relative to the private physicians

Why Did Some Universities Spin Off Their Hospitals?

- Multimillion dollar hospital malpractice settlements were perceived to put universities at risk.
- University Trustees were concerned about their overall credit ratings.
- Complexity of hospital finance and operational issues (e.g. shift differentials, bonus payments to nurses) made general university trustees nervous.
- Concern (on the clinical side) about the ability of a general university system to respond rapidly to change in the environment (managed care; especially capitation).
- Note: In the vast majority of divestitures, the outpatient clinics went into the university hospital 501(c)(3) and all technical revenue stayed with the hospital.

Long-Term Options for a Viable University Hospital

Goals: Access to Capital, Operating Efficiency and Contracting Leverage

- Stand alone
  - -- Two small hospitals without a shared bottom line (contracting pressure, high overhead)
  - -- Merge the hospitals (bond issues)
- Nonprofit systems
  - -- Baylor
  - -- Texas Health Resources
  - -- Methodist
- For profit systems
  - -- Hospital Corporation of America
  - -- Tenet
- UT Southwestern

What's Different Now?

- UTSW management team now has an experienced hospital management team in place.
- State deregulation allows flexibility in the marketplace that was not in place in the 1990's.
- UTSW, not the hospitals, has the major managed care contracting leverage in the marketplace.
- Our realization that two small, separate hospitals can not meet our long-term needs.

Financial Benefits

- Access to AAA-rated credit and debit capacity
  -- UT System bonds: low interest, tax exempt
- Low cost equipment financing
  -- UT System
- Reduced operating costs
- Hospital malpractice cost reduced to essentially zero
- Enhanced philanthropy
  -- Current status of the hospitals a substantial risk to philanthropy for both clinical and non-clinical programs

Projected Financial Ratios for 2004 With and Without Hospital Acquisition

Indicator	UTSW	UTSW with hospitals
Primary Reserve Ratio	267.2	201.33
Annual Operating Margin Ratio	1.0%	0.1%
Expendable Resources to Total Net Assets Ratio	37.1%	37.8%
Debt Burden Ratio	2.8%	2.4%
Debt Service Coverage Ratio	2.0	1.9
Return on Net Assets Ratio	4.4%	3.9%

UMC and UT Southwestern Combined Revenues FY 2004 (Projected)

(in millions)

	UT Southwestern*	UMC	Combined*
Net revenues from operations	$846.9	$291.7	$1.138.6
Operational Expenditures/ depreciation	$799.2	$298.3	$1097.5
Surplus/ (deficit) from operations	**$47.7**	**($6.6)**	**41.1**

*UTSW figures exclude capital projects and debt retirement

UT Southwestern Acquisition: Resulting Additions to Hospital Margins

Average annual fringe benefit savings	$1,300,000
Additional contract revenue	$3,000,000
Hospital malpractice expenses	$4,500,000
Cost of capital (5-year average-routine)	$800,000
Combined information systems	$1,500,000
General administration	$2,000,000
Physical plant operations/security	$1,000,000
Additional philanthropy	$10,000,000
TOTAL	**$24,100,000**

Non-Financial Benefits

- Optimal coordination of strategic planning, marketing, operations and patient care
- No longer have to negotiate with a separate legal entity with its own judiciary responsibilities.
- Brand Identity in the Marketplace
  - -- UT Southwestern widely known, St. Paul/Zale Lipshy barely known
- UT Southwestern can make decisions that are solely in the best interest of the institution
  - -- Increased faculty involvement in inpatient decisions
  - -- We can place programs in their ideal reimbursement environment

Transaction Issues

- UT System approval & timing
- Defeasance of Zale Lipshy bonds
- Status of employees
- Handling of prior liabilities
- Board interactions
- St. Paul private physicians

Summary

- The benefits of UT Southwestern acquiring and operating the hospitals greatly exceed the risk.
- The potential risk/costs to UT Southwestern relate to negative operating margins at St. Paul, which can be effectively managed.
- Access to UT System capital, liability protection, reduced duplication and improved operating efficiencies, enhanced contracting strength, and a regionally and nationally recognized identity for the combined clinical enterprise under the UT Southwestern name are important benefits individually; together they are overwhelmingly compelling.
- There is no other viable option