

# Advocate Aurora Health, Inc. and its Affiliates and Subsidiaries

Interim Unaudited Condensed Consolidated Financial Statements and Other Information  
As of and For the Period Ended June 30, 2018



Document Dated as of August 28, 2018

# ADVOCATE AURORA HEALTH, INC. AND ITS AFFILIATES AND SUBSIDIARIES

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**ADVOCATE AURORA HEALTH, INC. AND ITS AFFILIATES AND SUBSIDIARIES**  
**INTERIM UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEET**  
(Dollars in thousands)

	<b>June 30, 2018</b>
<b>ASSETS</b>	
<b>CURRENT ASSETS:</b>	
Cash and cash equivalents	\$ 395,951
Investments	1,510,867
Assets limited as to use	111,501
Patient accounts receivable	1,539,035
Inventories	153,011
Other current assets	306,439
Estimated third-party payor settlements	23,658
Collateral proceeds under securities lending program	13,453
Total current assets	4,053,915
Assets limited as to use:	
Externally designated under debt agreements	18,712
Board-designated and other	5,649,526
Contractually-restricted	685,089
Donor restricted	122,088
Investments under securities lending program	13,069
Total assets limited as to use	6,488,484
Property and equipment, net	5,439,162
<b>OTHER ASSETS:</b>	
Intangible assets and goodwill, net	85,781
Investments in unconsolidated entities	211,533
Reinsurance receivable	72,754
Other noncurrent assets	371,373
Total other assets	741,441
<b>TOTAL</b>	<b><u>\$ 16,723,002</u></b>

(Continued)

**ADVOCATE AURORA HEALTH, INC. AND ITS AFFILIATES AND SUBSIDIARIES**  
**INTERIM UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEET**  
(Dollars in thousands)

	<b>June 30, 2018</b>
<b>LIABILITIES AND NET ASSETS</b>	
<b>CURRENT LIABILITIES:</b>	
Current portion of long-term debt	\$ 175,679
Long-term debt subject to short-term remarketing	134,770
Accounts payable and accrued liabilities	1,391,807
Estimated third-party payor settlements	395,958
Current portion of accrued insurance and claim costs	124,046
Collateral under securities lending program	13,453
Total current liabilities	2,235,713
<b>NONCURRENT LIABILITIES:</b>	
Long-term debt, less current portion	2,727,605
Accrued insurance and claims cost, less current portion	641,440
Accrued losses subject to insurance recovery	72,754
Obligations under swap agreements	61,309
Other noncurrent liabilities	548,330
Total noncurrent liabilities	4,051,438
Total liabilities	6,287,151
<b>NET ASSETS:</b>	
Unrestricted:	
Controlling interest	10,097,357
Noncontrolling interest in subsidiaries	110,497
Total unrestricted net assets	10,207,854
Temporarily restricted	155,348
Permanently restricted	72,649
Total net assets	10,435,851
<b>TOTAL</b>	<b>\$ 16,723,002</b>

(Concluded)

See accompanying notes to interim unaudited condensed consolidated financial statements.

**ADVOCATE AURORA HEALTH, INC. AND ITS AFFILIATES AND SUBSIDIARIES**  
**INTERIM UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS AND**  
**CHANGES IN NET ASSETS**  
**(Dollars in thousands)**

	<b>Three Months Ended June 30, 2018</b>
REVENUE:	
Net patient service revenue	\$ 2,462,661
Capitation revenue	332,803
Other revenue	200,301
Total revenue	2,995,765
EXPENSES:	
Salaries, wages and benefits	1,613,838
Supplies and purchased services	731,102
Contract medical services	153,770
Depreciation and amortization	136,241
Interest	26,864
Other	212,164
Total expenses	2,873,979
OPERATING INCOME BEFORE NONRECURRING LOSSES	121,786
Nonrecurring losses	14,545
OPERATING INCOME	107,241
NONOPERATING INCOME:	
Investment income, net	44,796
Other nonoperating income, net	6,667
Total nonoperating income, net	51,463
EXCESS OF REVENUE OVER EXPENSES	158,704
Less noncontrolling interest	(12,451)
EXCESS OF REVENUE OVER EXPENSES - attributable to controlling interest	\$ 146,253

(Continued)

**ADVOCATE AURORA HEALTH, INC. AND ITS AFFILIATES AND SUBSIDIARIES**  
**INTERIM UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS AND**  
**CHANGES IN NET ASSETS**

(Dollars in thousands)

	<b>Three Months Ended June 30, 2018</b>
<b>Unrestricted net assets, controlling interest:</b>	
Excess of revenue over expenses	\$ 146,253
Pension-related changes other than net periodic pension costs	2,742
Net assets released from restrictions for purchase of property and equipment	2,713
Other, net	1,840
Increase in unrestricted net assets, controlling interest	153,548
<b>Unrestricted net assets, noncontrolling interest:</b>	
Excess of revenue over expenses	12,451
Distributions to noncontrolling interest	(6,611)
Other, net	(81)
Increase in unrestricted net assets, noncontrolling interest	5,759
<b>Temporarily restricted net assets:</b>	
Contributions	4,559
Investment income, net	268
Net assets released from restrictions for operations	(4,902)
Net assets released from restrictions for purchase of property and equipment	(2,713)
Other, net	(1,131)
Decrease in temporarily restricted net assets	(3,919)
<b>Permanently restricted net assets:</b>	
Contributions	71
Other, net	(1)
Increase in permanently restricted net assets	70
Increase in net assets	155,458
Net assets at beginning of period	10,280,393
Net assets at end of period	<u><u>\$ 10,435,851</u></u>

(Concluded)

See accompanying notes to interim unaudited condensed consolidated financial statements.

**ADVOCATE AURORA HEALTH, INC. AND ITS AFFILIATES AND SUBSIDIARIES**  
**INTERIM UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS**  
**(Dollars in thousands)**

	<b>Three Months Ended June 30, 2018</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>	
Increase in net assets	\$ 155,458
Adjustments to reconcile change in net assets to net cash provided by operating activities:	
Depreciation, amortization and accretion	134,441
Gain on sale of property and equipment	(1,122)
Change in fair value of swap agreements	(5,060)
Pension-related changes other than net periodic pension cost	(2,742)
Restricted contributions and gains on investments, net of assets released from restrictions used for operations	(3,308)
Distribution to noncontrolling interest	24,348
<b>Changes in operating assets and liabilities:</b>	
Trading securities, net	(95,307)
Accounts receivable, net	(68,322)
Accounts payable and accrued liabilities	(59,587)
Estimated third-party payor settlements, net	71,467
Other assets and liabilities, net	3,568
Net cash provided by operating activities	<u>153,834</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>	
Capital expenditures	(146,545)
Proceeds from sale of property and equipment	1,868
Sales of investments designated as non-trading, net	15,774
Investments in unconsolidated entities, net	(864)
Other	9,041
Net cash used in investing activities	<u>(120,726)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>	
Repayments of long-term debt and other obligations	(24,589)
Distribution to noncontrolling interest	(24,348)
Proceeds from restricted contributions and gains on investments	3,675
Net cash used in financing activities	<u>(45,262)</u>
<b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(12,154)</b>
<b>CASH AND CASH EQUIVALENTS:</b>	
Beginning of period	408,105
End of period	<u><u>\$ 395,951</u></u>

See accompanying notes to interim unaudited condensed consolidated financial statements.

**ADVOCATE AURORA HEALTH, INC. AND ITS AFFILIATES AND SUBSIDIARIES**  
**NOTES TO INTERIM UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE PERIOD ENDED JUNE 30, 2018**

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**1. ORGANIZATION AND BASIS OF PRESENTATION**

**Description Of Business**

On April 1, 2018, Advocate Aurora Health, Inc., a Delaware nonprofit corporation (the Parent Corporation) became the sole corporate member of Advocate Health Care Network, an Illinois not-for-profit corporation (AHCN or Advocate) and Aurora Health Care, Inc., a Wisconsin nonstock not-for-profit corporation (Aurora) (the Affiliation). The Parent Corporation, Advocate and Aurora and their controlled subsidiaries and controlled affiliates are collectively referred to herein as the “System”. The System was formed on April 1, 2018 in furtherance of the parties’ common and unifying charitable health care mission to promote and improve the quality and expand the scope and accessibility of affordable health care and health-care related services for the communities they serve.

The System is comprised of various not-for-profit and for-profit entities, the primary activities are the delivery of health care services or the provision of goods and services ancillary thereto.

The System provides a continuum of care through its 25 acute care hospitals, an integrated children’s hospital and a psychiatric hospital, which in total have 6,573 licensed beds, primary and specialty physician services, outpatient centers, physician office buildings, pharmacies, behavioral health care, rehabilitation and home health and hospice care in northern and central Illinois and eastern Wisconsin.

**Basis of Presentation**

The accompanying interim unaudited condensed consolidated financial statements for the quarter ended June 30, 2018 have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim reporting. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The interim unaudited condensed consolidated financial statements do not include all the information and footnotes required by GAAP for annual financial statements. Operating results for the quarter ended June 30, 2018 are not necessarily indicative of the results that may be experienced for the period ending December 31, 2018.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Use of Estimates**

The preparation of condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses as of the date and period of the condensed consolidated financial statements. Actual results could differ from those estimates.

**Cash Equivalents**

The System considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.



## **Investments**

The System has designated substantially all of its investments as trading. Investments in debt and equity securities with readily determinable fair values are measured at fair value using quoted market prices or otherwise observable inputs. Investments in private equity limited partnerships and in limited partnerships that invest in marketable securities and derivative products (hedge funds) are reported at fair value. Commingled funds are carried at fair value based on other observable inputs. Investment income or loss (including realized gains and losses, interest, dividends, changes in equity of limited partnerships and unrealized gains and losses) is included in investment income unless the income or loss is restricted by donor or law or is related to assets designated for self-insurance programs. Investment income on self-insurance trust funds is reported in other revenue. Investment income that is restricted by donor or law are reported as a change in temporarily restricted net assets.

## **Assets Limited as to Use**

Assets limited as to use consist of investments set aside by the Board of Directors for future capital improvements and certain medical education and other health care programs. The Board of Directors retains control of these investments and may, at its discretion, subsequently use them for other purposes. Additionally, assets limited as to use include investments held by trustees or in trust under debt agreements, self-insurance trusts, assets held in reinsurance trust accounts, and other contractually restricted funds and donor-restricted funds.

## **Patient Service Revenue and Accounts Receivable**

Net patient service revenue is reported at the amount that reflects the consideration to which the System expects to be entitled in exchange for providing patient care. These amounts are due from patients, third-party payers (including managed care payers and government programs) and others and includes variable consideration for retroactive revenue adjustments due to settlement of audits, reviews and investigations. Generally, patients and third-party payers are billed within days after the services are performed or shortly after discharge. Revenue is recognized as performance obligations are satisfied. Provisions for third-party payor settlements and adjustments are estimated in the period the related services are provided and adjusted in future periods as additional information becomes available and final settlements are determined.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is a possibility that recorded estimates will change by a material amount.

## **Inventories**

Inventories, consisting primarily of medical supplies, pharmaceuticals and durable medical equipment, are stated at the lower of cost (first-in, first-out) or market. Retail pharmaceutical inventories are stated at replacement cost.

## **Reinsurance Receivables**

Reinsurance receivables are recognized in a manner consistent with the liabilities relating to the underlying reinsured contracts.

## **Intangible Assets and Goodwill, Net**

Goodwill of \$65.2 million is included in intangible assets and goodwill, net in the accompanying interim unaudited condensed consolidated balance sheet at June 30, 2018. Goodwill is not amortized and is evaluated for impairment at least annually. Intangible assets with expected useful lives are amortized over that period.

## **Asset Impairment**

The System considers whether indicators of impairment are present and performs the necessary tests to determine if the carrying value of an asset is appropriate. Impairment write-downs are recognized in operating income at the time the impairment is identified.

## **Property and Equipment, Net**

Property and equipment are reported at cost or, if donated, at fair value at the date of the gift. Costs of computer software developed or obtained for internal use, including external direct costs of materials and services and payroll and payroll-related costs for employees directly associated with internal-use software development projects, are capitalized and included in property and equipment. Interest expense incurred during the period of construction of significant capital projects is capitalized as a component of the costs of the asset.

Property and equipment capitalized under capital leases are recorded at the net present value of future minimum lease payments and are amortized on the straight-line method over the shorter of the related lease term or the estimated useful life of the asset. Amortization of property and equipment under capital leases is included in the accompanying interim unaudited condensed consolidated statement of operations and changes in net assets in depreciation and amortization expense.

Property and equipment assets are depreciated on the straight-line method over a period ranging from 3 years to 80 years.

## **Investments in Unconsolidated Entities**

Investments in unconsolidated entities are accounted for using the cost or equity method. The System applies the equity method of accounting for investments in unconsolidated entities when its ownership interest is 50% or less and the System has the ability to exercise significant influence over the operating and financial policies of the investee. All other unconsolidated entities are accounted for using the cost method. The income (loss) on unconsolidated entities is included in other operating revenue.

## **Derivative Financial Instruments**

The System has entered into transactions to manage its interest rate, credit and market risks. Derivative instruments, including exchange-traded and over-the-counter derivative contracts and interest rate swaps, are recorded as either assets or liabilities at fair value. Subsequent changes in a derivatives fair value are recognized in other nonoperating income, net.

## **Bond Issuance Costs, Discounts and Premiums**

Bond issuance costs, discounts and premiums are amortized over the term of the bonds using the effective interest method.

## **General and Professional Liability Risks**

The provision for self-insured general and professional liability claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported. The System measures the cost of its unfunded obligations under such programs based upon actuarial calculations and records a liability on a discounted basis.

## **Temporarily and Permanently Restricted Net Assets**

Temporarily restricted net assets are those assets whose use by the System has been limited by donors to a specific time period or purpose. Permanently restricted net assets consist of gifts with corpus values that have been restricted by donors to be maintained in perpetuity. Temporarily restricted net assets and earnings on permanently restricted net assets are used in accordance with the donor's wishes primarily to purchase property and equipment, and to fund medical education or other health programs.

Assets released from restrictions to fund purchases of property and equipment are reported in the interim unaudited condensed consolidated statement of operations and changes in net assets as increases to unrestricted net assets. Those assets released from restriction for operating purposes are reported in the interim unaudited condensed consolidated statement of operations and changes in net assets as other revenue. When restricted, earnings are recorded as temporarily restricted net assets until amounts are expended in accordance with the donor's specifications.

## **Other Nonoperating Income, Net**

Revenues and expenses from delivering health care services and other activities that are consistent with the System's ongoing major or central purposes are reported in operations. Income and losses that arise from transactions that are peripheral or incidental to the System's main purpose are included in other nonoperating income, net. Other nonoperating income, net primarily consists of the net expenses of the Advocate Charitable Foundation, contributions to charitable organizations, income taxes and the net periodic benefit income on the System's pension plans.

## **Excess of Revenues over Expenses**

The performance indicator is the excess of revenues over expenses. Changes in unrestricted net assets, which are excluded from excess of revenues over expenses, primarily include contributions of long-lived assets (including assets acquired using contributions, which by donor restriction were to be used for the purposes of acquiring such assets), pension-related changes other than net periodic pension costs and distributions to non-controlling interests.

## **Nonrecurring Losses**

The System has incurred salary, purchased services and other expenses in connection with the Affiliation and the implementation of an electronic medical records system. As a result, these costs were recorded as nonrecurring in the interim unaudited condensed consolidated statement of operations and changes in net assets.

## **Pronouncements Adopted**

In March 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*, related to the presentation of net periodic pension cost and net periodic postretirement benefit costs. This new guidance requires that the service cost component be reported in the same line item as compensation costs arising from services rendered by the pertinent employees during the period. The other components of net pension and postretirement benefit costs are required to be presented separately from the service cost component and outside a subtotal of income from operations. This standard was adopted by both Advocate and Aurora prior to the Affiliation, using the practical expedient which allows amounts disclosed in the retirement plans note for the prior comparative periods to serve as the basis for estimation when applying the retrospective presentation requirements. Therefore, the System is following this guidance.

In May 2014, FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The core principle of the guidance in ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Both Advocate and Aurora adopted this guidance as of January 1, 2018. Therefore, the System is following this guidance.

As the System's performance obligations relate to contracts with a duration of less than one year, the System has elected to apply the optional exemption provided in the guidance and, therefore, is not required to disclose the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied or partially unsatisfied at the end of the reporting period. The unsatisfied or partially unsatisfied performance obligations referred to above are primarily related to inpatient acute care services at the end of the reporting period. The performance obligations for these contracts are generally completed when the patients are discharged, which generally occurs within days or weeks of the end of the reporting period.

As provided for under the guidance, the System does not adjust the promised amount of consideration from patients and third-party payers for the effects of a significant financing component due to the expectation that the period between the time the service is provided to a patient and the time that the patient or a third-party payer pays for that service will be one year or less.

The System has entered into payment arrangements with patients that allow for payments over a term in excess of one year. The System has evaluated historical collections in excess of one year and current market interest rates to determine whether a significant financing component exists which would require an adjustment to the promised amount of consideration from patients and third-party payers. The System has determined that the impact of implicit financing arrangements for payment agreements in excess of one year is insignificant to the interim unaudited condensed consolidated statement of operations and changes in net assets.

The System does not incur significant incremental costs in obtaining contracts with patients. As permitted in the guidance, any costs which are incurred, are expensed in the period of occurrence, as the amortization period of any asset that the System would have recognized is one year or less in duration.

In January 2016, the FASB issued ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities* which requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment. In addition, the guidance simplifies the impairment assessment of equity investments without readily determinable fair values and eliminates certain disclosures. This standard is effective for the System as of January 1, 2019. The System early adopted this standard as of April 1, 2018 and elected to measure its investments in private equity limited partnerships, previously carried at cost, at fair value.

### **Pronouncements Not Yet Adopted**

In November 2016, the FASB issued ASU 2016-18, *Restricted Cash*. This guidance will require restricted cash and restricted cash equivalents to be included with cash and cash equivalents when reconciling the beginning of period and end of period total amounts shown on the consolidated statement of cash flows. This guidance is effective for the fiscal years and interim periods within those fiscal years beginning after December 15, 2018. The System will adopt this standard January 1, 2019. Management does not anticipate that this guidance will have a material impact on its consolidated statement of cash flows.

In August 2016, the FASB issued ASU 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*. The guidance will require net assets to be categorized either as net assets with donor restrictions

or net assets without donor restrictions rather than the currently required three classes of net assets. The guidance also requires additional quantitative and qualitative disclosures related to liquidity and financial performance, as well as, disclosure of expenses by their natural and functional classifications. This guidance is effective for annual reporting periods after December 31, 2017. The System will adopt this standard for annual reporting as of December 31, 2018. Management does not believe this standard will have a significant impact on its consolidated financial position, results of operations and cash flows.

In August 2016, the FASB issued ASU 2016-15, *Classification of Certain Cash Receipts and Cash Payments*, which amends guidance in Accounting Standards Codification (ASC) 230 on the classification of certain cash receipts and payments in the statement of cash flows. This standard is effective for the System beginning January 1, 2019. Management does not anticipate that this this guidance will have a material impact on its consolidated statement of cash flows, with the primary change being the movement of certain distributions from equity method investees from cash used in investing activities to cash flows from operations.

In February 2016, the FASB issued ASU 2016-02, *Leases*. This guidance introduces a lessee model that brings most leases on to the balance sheet. The standard also aligns certain of the underlying principles of the new lessor model with those in this guidance ASU 2014-09, the new revenue recognition standard. This standard is effective for the System as of January 1, 2019. Management is currently in the process of evaluating the impact of this guidance on its consolidated financial position, results of operations and cash flows.

### **3. REVENUE AND RECEIVABLES**

#### **Net Patient Service Revenue**

Net patient service revenue is reported at the amount that reflects the consideration to which the System expects to be entitled in exchange for providing patient care. These amounts are due from patients, third-party payers (including managed care payers and government programs) and others, and includes variable consideration for retroactive revenue adjustments due to settlement of audits, reviews and investigations. Generally, patients and third-party payers are billed within days after the services are performed or shortly after discharge. Revenue is recognized as performance obligations are satisfied.

Performance obligations are identified based on the nature of the services provided. Revenue associated with performance obligations satisfied over time is recognized based on actual charges incurred in relation to total expected (or actual) charges. Performance obligations satisfied over time relate to patients receiving inpatient acute care services. The System measures the performance obligation from admission into the hospital to the point when there are no further services required for the patient, which is generally the time of discharge. For outpatient services, the performance obligation is satisfied as the patient simultaneously receives and consumes the benefits provided as the services are performed. In the case of these outpatient services, recognition of the obligation over time yields the same result as recognizing the obligation at a point in time. Management believes this method provides a faithful depiction of the transfer of services over the term of performance obligations based on the inputs needed to satisfy the obligations.

The System uses a portfolio approach to account for categories of patient contracts as a collective group rather than recognizing revenue on an individual contract basis. The portfolios consist of major payor classes for inpatient revenue and major payor classes and types of services provided for outpatient revenue. Based on the historical collection trends and other analyzes, the System believes that revenue recognized by utilizing the portfolio approach approximates the revenue that would have been recognized if an individual contract approach were used.

The System determines the transaction price, which involves significant estimates and judgment, based on standard charges for goods and services provided, reduced by explicit and implicit price concessions,

including contractual adjustments provided to third-party payers, discounts provided to uninsured and underinsured patients in accordance with policy and/or implicit price concessions based on the historical collection experience of patient accounts. The System determines the transaction price associated with services provided to patients who have third-party payor coverage based on reimbursement terms per contractual agreements, discount policies and historical experience. For uninsured (and underinsured in the case of Advocate) patients who do not qualify for charity care, the System determines the transaction price associated with services on the basis of charges reduced by implicit price concessions. Implicit price concessions included in the estimate of the transaction price are based on historical collection experience for applicable patient portfolios. Patients who meet the System's criteria for free care "charity" are provided care without charge; such amounts are not reported as revenue. Subsequent changes to the estimate of the transaction price are generally recorded as adjustments to net patient service revenue in the period of the change. Settlements with third-party payers for retroactive adjustments due to audits, reviews or investigations are considered variable consideration and are included in the determination of the estimated transaction price for providing patient care using the most likely outcome method. These settlements are estimated based on the terms of the payment agreements with the payer, correspondence from the payer and historical settlement activity, including an assessment to ensure that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the retroactive adjustment is subsequently resolved. Estimated settlements are adjusted in future periods as new information becomes available or as years are settled or are no longer subject to such audits, reviews and investigations.

For the three months ended June 30, 2018, changes in the System's estimates of implicit price concessions, discounts and contractual adjustments or other reductions to expected payments for performance obligations in prior years were not significant.

In certain instances, the System does receive payment in advance of the services provided and would consider these amounts to represent contract liabilities. Contract liabilities at June 30, 2018 were not significant.

Currently, Illinois utilizes supplemental reimbursement programs to supplement reimbursement to providers to offset a portion of the cost of providing care to Medicaid and indigent patients. These programs are designed with input from the Centers for Medicare & Medicaid Services and are funded with a combination of state and federal resources including assessments levied on the providers. Under these supplemental programs, the System recognizes revenue and related expenses in the period in which amounts are estimable and collection is reasonably assured. Reimbursement under these programs is reflected in net patient service revenue and the assessment is reflected in other expense in the interim unaudited condensed consolidated statement of operations and changes in net assets. For the three months ended June 30, 2018 net patient service revenue includes \$65.3 million related to this program, and expenses include \$42.3 million, of tax assessment fees.

Wisconsin assesses a fee or tax on gross patient service revenue. The revenues from this assessment are used to increase payments made to hospitals for services provided to Medicaid and other medically indigent patients. The System's patient service revenue reflects this increase in payment for services to Medicaid and other medically indigent patients and hospital tax assessment expense reflects the fees assessed by the State. For the three months ended June 30, 2018 net patient service revenue includes \$25.0 million, related to this program, and expenses include \$24.5 million, of tax assessment fees.

The System has filed formal appeals relating to the settlement of certain prior-year Medicare cost reports. The outcome of these appeals cannot be determined at this time.

Management has determined that the nature, amount, timing and uncertainty of revenue and cash flows are affected by the payors geographical location, the line of business that renders services to patients and the timing of when revenue is recognized and billed. The composition of net patient service revenue by payor for the three months ended June 30, 2018 is as follows (dollars in thousands):

Managed care	\$ 1,378,176	56%
Medicare	741,340	30%
Medicaid - Wisconsin	99,498	4%
Medicaid - Illinois	176,912	7%
Self-pay and other	66,735	3%
	<u>\$ 2,462,661</u>	<u>100%</u>

Deductibles, copayments and coinsurance under third-party payment programs which are the patient's responsibility are included within the primary payor category in the table above.

The composition of net patient service revenue by market and service line for the three months ended June 30, 2018 is as follows (dollars in thousands):

	Wisconsin	Illinois	Other System	Net Patient Service Revenue	Percent of Total
Hospital	\$ 887,781	\$ 958,378	\$ —	\$ 1,846,159	75 %
Clinic	392,916	148,657	—	541,573	22 %
Home Health	28,900	22,262	—	51,162	2 %
Other	4,469	20,398	(1,100)	23,767	1 %
<b>Total</b>	<u>\$ 1,314,066</u>	<u>\$ 1,149,695</u>	<u>\$ (1,100)</u>	<u>\$ 2,462,661</u>	<u>100%</u>

### Capitation Revenue

The System has agreements with various managed care organization under which the System provides or arranges for medical care to members of the organizations in return for a monthly payment per member. Revenue is earned each month as a result of agreeing to provide or arrange for their medical care.

Substantially all of the System's capitation revenue relates to the Illinois market.

### Other Revenue

Other revenue is recognized at an amount that reflects the consideration to which the System expects to be entitled in exchange for providing goods and services. The amounts recognized reflect consideration due from customers, third-party payers and others. Primary categories of other revenue include income from joint ventures, pharmacy revenue, grant revenue, cafeteria revenue, rent and lease revenue and other.

### Patient Accounts Receivable

The System's patient accounts receivable is reported at the amount that reflects the consideration to which it expects to be entitled, in exchange for providing patient care.

The revenue related to patient accounts receivable are reported at net realizable value based on certain assumptions. For third-party payors including Medicare, Medicaid and Managed Care, the net realizable value is based on the estimated contractual reimbursement percentage, which is based on current contract

prices or historical paid claims data by payor. For self-pay, the net realizable value is determined using estimates of historical collection experience including an analysis by aging category. These estimates are adjusted for expected recoveries and any anticipated changes in trends including significant changes in payor mix, shared revenue cycle operations, economic conditions or trends in federal and state governmental healthcare coverage.

The composition of patient accounts receivable is summarized as follows, (dollars in thousands):

	<b>June 30, 2018</b>		<b>April 1, 2018</b>	
Managed care	\$	667,396	43%	\$ 607,349 40%
Medicare		291,808	19%	261,674 17%
Medicaid - Wisconsin		44,288	3%	45,394 3%
Medicaid - Illinois		196,149	13%	269,282 18%
Self-pay and other		339,394	22%	332,408 22%
	<u>\$</u>	<u>1,539,035</u>	<u>100%</u>	<u>\$ 1,516,107 100%</u>

The self-pay patient accounts receivable above includes amounts due from patients for co-insurance, deductibles, installment payment plans and amounts due from patients without insurance.



#### 4. INVESTMENTS

The System has designated substantially all of its investments as trading. Investments in debt and equity securities with readily determinable fair values are measured at fair value using quoted market prices or otherwise observable inputs. Investments in private equity limited partnerships and in limited partnerships that invest in marketable securities and derivative products (hedge funds) are reported at fair value. Commingled funds are carried at fair value based on other observable inputs.

Receivables and payables for investment trades not settled are presented within other current assets and accounts payable and accrued liabilities. Unsettled sales resulted in receivables due from brokers of \$13.7 million at June 30, 2018. Unsettled purchases resulted in payables of \$58.0 million at June 30, 2018.

Investment income or loss (including realized gains and losses, interest, dividends, changes in equity of limited partnerships and unrealized gains and losses) is included in investment income unless the income or loss is restricted by donor or law or is related to assets designated for self-insurance programs. Investment income on self-insurance trust funds is reported in other operating revenue. Gains and losses that are restricted by donor or law are reported as a change in temporarily restricted net assets.

Investment returns for assets limited as to use, cash and cash equivalents and investments are comprised of the following for the three months ended June 30, 2018, (dollars in thousands):

Interest income and dividends	\$ 25,879
Equity income from alternative investments	58,654
Net realized gains on securities	22,781
Net unrealized losses on investments	(50,773)
Total	<u>\$ 56,541</u>

Investment returns are included in the interim unaudited condensed consolidated statement of operations and changes in net assets as follows for the three months ended June 30, 2018 (dollars in thousands):

Other revenue	\$ 11,477
Investment income, net	44,796
Temporarily restricted net assets	268
Total	<u>\$ 56,541</u>

Investments in hedge funds totaled \$2,180.3 million at June 30, 2018. Investments in private equity limited partnerships totaled \$1,014.7 million at June 30, 2018. At June 30, 2018, the System had commitments to fund, including callable distributions, an additional \$988.6 million to private equity limited partnerships over approximately the next seven years.

#### 5. FAIR VALUE

The System accounts for certain assets and liabilities at fair value and categorizes assets and liabilities measured at fair value in the interim unaudited condensed consolidated financial statements based upon whether the inputs used to determine their fair values are observable or unobservable. Observable inputs are inputs which are based on market data obtained from sources independent of the reporting entity. Unobservable inputs are inputs that reflect the reporting entity's own assumptions about pricing the asset or liability, based on the best information available under the circumstances.

The fair value of all assets and liabilities recognized or disclosed at fair value are classified based on the lowest level of significant inputs. Assets and liabilities that are measured at fair value are disclosed and classified in one of the three categories. Category inputs are defined as follows:

*Level 1* — Quoted prices (unadjusted) in active markets for identical assets or liabilities on the reporting date.

*Level 2* — Inputs other than quoted market prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability.

*Level 3* — Inputs that are unobservable for the asset or liability for which there is little or no market data.

The following section describes the valuation methodologies used by the System to measure financial assets and liabilities at fair value. In general, where applicable, the System uses quoted prices in active markets for identical assets and liabilities to determine fair value. This pricing methodology applies to Level 1 investments such as domestic and international equities, United States Treasuries, exchange-traded funds and agency securities.

If quoted prices in active markets for identical assets and liabilities are not available to determine fair value, then quoted prices for similar assets and liabilities or inputs other than quoted prices that are observable either directly or indirectly are used. These investments are included in Level 2 and consist primarily of corporate notes and bonds, foreign government bonds, mortgage-backed securities, fixed income securities, including fixed income government obligations; commercial paper and certain agency, United States and international equities, which are not traded on an active exchange. The fair value for the obligations under swap agreements included in Level 2 is estimated using industry standard valuation models. These models project future cash flows and discount the future amounts to a present value using market-based observable inputs, including interest rate curves. The fair values of the obligation under swap agreements include adjustments related to the System's credit risk.

Investments owned by the System are exposed to various kinds and levels of risk. Equity securities and equity funds expose the entity to market risk, performance risk and liquidity risk for both domestic and international investments. Market risk is the risk associated with major movements of the equity markets. Performance risk is that risk associated with a company's operating performance. Fixed income securities and fixed income mutual funds expose the System to interest rate risk, credit risk and liquidity risk. As interest rates change, the value of many fixed income securities is affected, including those with fixed interest rates. Credit risk is the risk that the obligor of the security will not fulfill its obligations. Liquidity risk is affected by the willingness of market participants to buy and sell particular securities. Liquidity risk tends to be higher for equities related to small capitalization companies and certain alternative investments. Due to the volatility in the capital markets, there is a reasonable possibility of subsequent changes in fair value resulting in additional gains and losses in the near term.

In the normal course of operations and within established investment policy guidelines, the System may enter into various exchange-traded and over-the counter derivative contracts for trading purposes, including futures, options and forward contracts. These instruments are used primarily to maintain the System's strategic asset allocation, adjust the portfolio duration, modify term structure exposure, and change sector exposure and arbitrage market inefficiencies. These instruments require the System to deposit cash collateral with the broker or custodian. At June 30, 2018, the collateral provided was \$15.9 million. At June 30, 2018, the notional value of the derivatives in long positions were \$104.6 million and those in a short position were \$1.5 million.

By using derivative financial instruments, the System exposes itself to credit risk and market risk. Credit risk is the failure of the counterparty to perform under the terms of the derivative contracts. When the fair value of a derivative contract is positive, the counterparty owes the System, which creates credit risk for the System. When the fair value of a derivative contract is negative, the System owes the counterparty, and therefore, it does not possess credit risk. The System minimizes the credit risk in derivative instruments by entering into transactions that may require the counterparty to post collateral for the benefit of the System based on the credit rating of the counterparty and the fair value of the derivative contract. Market risk is the adverse effect on the value of a financial instrument that results from a change in the underlying reference security. The market risk associated with market changes is managed by establishing and monitoring parameters that limit the types and degree of market risk that may be undertaken.

The carrying values of cash and cash equivalents, accounts receivable and payable, accrued liabilities and short-term borrowings are reasonable estimates of their fair values due to the short-term nature of these financial instruments.

The fair values of financial assets and liabilities that are measured by the level of significant input as of June 30, 2018 are as follows (dollars in thousands):

	<b>June 30, 2018</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Other Significant Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
<b><u>Assets</u></b>				
<b><u>Investments</u></b>				
Cash and short-term investments	\$ 544,643	\$ 440,980	\$ 103,663	\$ —
Corporate bonds and other debt securities	522,378	—	522,378	—
United States government bonds	557,972	—	557,972	—
Bond and other debt security funds	1,245,204	101,522	1,143,682	—
Non-government fixed-income obligations	25,907	—	25,907	—
Equity securities	1,007,673	1,007,673	—	—
Equity funds	1,408,067	679,560	728,507	—
	5,311,844	2,229,735	3,082,109	—
<b>Investments at net asset value:</b>				
Hedge funds	2,180,265			
Private equity limited partnerships	1,014,694			
<b>Total investments</b>	<b>\$ 8,506,803</b>			
<b>Collateral proceeds received under securities lending program</b>	<b>\$ 13,453</b>		<b>\$ 13,453</b>	
<b><u>Liabilities</u></b>				
<b>Obligations under interest rate swap agreements</b>	<b>\$ (61,309)</b>		<b>\$ (61,309)</b>	
<b>Obligations to return capital under securities lending program</b>	<b>\$ 13,453</b>		<b>\$ 13,453</b>	

## 6. PROPERTY AND EQUIPMENT

The components of property and equipment at June 30, 2018, is summarized as follows (dollars in thousands):

	<b>As of June 30, 2018</b>
Land and improvements	\$ 439,457
Buildings and fixed equipment	6,928,611
Movable equipment and computer software	2,860,995
Construction-in-progress	<u>221,137</u>
Total property and equipment	10,450,200
Accumulated depreciation and amortization	<u>(5,011,038)</u>
Property and equipment, net	<u><u>\$ 5,439,162</u></u>

Property and equipment includes net assets under capitalized leases and other financing arrangements totaling \$130.5 million (gross of \$196.3 million, accumulated amortization of \$65.8 million) at June 30, 2018.

## 7. INVESTMENTS IN UNCONSOLIDATED ENTITIES

The System has a 49% interest in Bay Area Medical Center (BAMC), a 99 bed general acute care hospital located in Marinette, Wisconsin. The System's investment in BAMC is accounted for under the equity method of accounting and is presented within investments in unconsolidated entities in the accompanying interim unaudited consolidated balance sheet. The System's investment in BAMC as of June 30, 2018 was \$25.2 million. The carrying amount of the System's investment in BAMC was \$35.7 million less than the underlying equity in the net assets of BAMC as of June 30, 2018. This difference represents a contingent gain which would be recognized in the event of dissolution of BAMC or if the System's interest in BAMC were to increase requiring BAMC to be included in the interim unaudited condensed consolidated financial statements of the System.

The System has a 27% interest in Aurora Bay Area Medical Group (ABAMG), which provides inpatient, outpatient and other necessary professional medical services in Marinette, Wisconsin and its surrounding communities. BAMC owns the remaining 73% of ABAMG. The System's investment in ABAMG is accounted for under the equity method and is presented within investments in unconsolidated entities in the accompanying interim unaudited condensed consolidated balance sheet. The System leases employees and buildings to ABAMG and recognized \$4.2 million of other revenue for the three months ended June 30, 2018 under these leasing agreements. The System made additional capital contributions to ABAMG of \$1.5 million during the three months ended June 30, 2018. The System's investment in ABAMG was \$0.1 million as of June 30, 2018.

In connection with the acquisition of a medical center, the System acquired an interest in the net assets of the Masonic Family Health Foundation (MFHF), an independent organization, under the terms of an asset purchase agreement (the Agreement). The use of substantially all of MFHF's net assets are designated to support the operations and/or capital needs of one of the System's medical facilities. Additionally, 90% of MFHF's investment yield, net of expenses, on substantially all of MFHF's investments is designated for the support of one of the System's medical facilities. MFHF must pay the System, annually, 90% of the investment yield or an agreed-upon percentage of the beginning of the year net assets.

The interest in the net assets of this organization amounted to \$88.8 million as of June 30, 2018 and is presented within investments in unconsolidated entities in the accompanying interim unaudited condensed consolidated balance sheet. The System's interest in the investment yield is reflected in the interim unaudited condensed consolidated statement of operations and changes in net assets and amounted to \$1.7 million for the three months ended June 30, 2018. There were no cash distributions received by the System from MFHF under terms of the Agreement during the three months ended June 30, 2018. In addition, MFHF made no contributions to the System for program support of one of its medical facilities during the three months ended June 30, 2018.

At June 30, 2018, the System has a 49.5% ownership interest in RML Health Providers, L.P. (RML) that is accounted for on an equity basis. RML is an Illinois not-for-profit limited partnership that operates a 115-bed licensed long-term acute care hospital in Hinsdale, Illinois and 86-bed licensed long-term acute care hospital in Chicago, Illinois. The System's carrying value of this interest was \$33.0 million at June 30, 2018 and is presented within investments in unconsolidated entities in the accompanying interim unaudited condensed consolidated balance sheet.

RML leases the Chicago, Illinois facility from the System. The lease has a fixed term through June 30, 2020 with a five-year renewal term remaining executable at the option of RML. The System recorded rental income of \$0.3 million for the three months ended June 30, 2018.

The summarized financial position and results of operations for significant entities accounted for under the equity method as of and for the period ended June 30, 2018 is as follows (dollars in thousands):

	<b>Bay Area Medical Center</b>	<b>ABAMG</b>	<b>RML</b>	<b>MFHF</b>
Total assets	\$ 225,854	\$ 4,990	\$ 122,627	\$ 91,388
Total liabilities	101,803	4,635	62,247	2,739
Equity	124,051	355	60,380	88,649
Total revenue	26,098	5,205	27,873	679
Net income (loss)	3,014	(6,425)	3,687	171

## 8. LONG-TERM DEBT

Long-term debt at June 30, 2018 is summarized as follows (dollars in thousands):

	<b>June 30, 2018</b>
Revenue bonds and revenue refunding bonds, Illinois Finance Authority (IFA):	
Series 2003A (weighted average rate of 1.38%)	\$ 12,577
Series 2003C (weighted average rate of 1.60%)	12,589
Series 2008A (weighted average rate of 5.00%)	124,820
Series 2008C (weighted average rate of 1.46%)	342,634
Series 2008D (weighted average coupon of 5.50%)	4,924
Series 2010D (weighted average coupon of 4.00%)	15,095
Series 2011A (weighted average coupon of 5.00%)	32,380
Series 2011B (weighted average rate of 1.77%)	69,262
Series 2011C (weighted average rate of 2.10%)	49,704
Series 2011D (weighted average rate of 2.10%)	49,704
Series 2012 (weighted average coupon of 4.26%)	147,869
Series 2013A (weighted average coupon of 5.00%)	93,539
Series 2014 (weighted average coupon of 4.80%)	331,703
Series 2015 (weighted average coupon of 4.63%)	102,762
Series 2015B (weighted average coupon of 4.19%)	72,449
Total IFA debt	<u>1,462,011</u>
Revenue bonds, Wisconsin Health and Educational Facilities Authority (WHEFA):	
Series 1999C (weighted average coupon of 1.49%)	50,000
Series 2008A (weighted average coupon of 1.31%)	80,000
Series 2008B (weighted average coupon of 1.56%)	79,470
Series 2009A (weighted average coupon of 5.16%)	22,500
Series 2010A (weighted average coupon of 5.46%)	152,935
Series 2010B (weighted average coupon of 5.00%)	41,620
Series 2010C (weighted average coupon of 1.40%)	102,465
Series 2012A (weighted average coupon of 4.76%)	203,885
Series 2012B (weighted average coupon of 1.38%)	36,000
Series 2012C (weighted average coupon of 1.38%)	36,000
Series 2012D (weighted average coupon of 1.44%)	53,115
Series 2013A (weighted average coupon of 5.19%)	115,750
Unamortized original issue premium, net	9,131
Total WHEFA debt	<u>982,871</u>
Taxable bonds:	
Taxable Bond Series 2015A (weighted average coupon of 2.43%)	40,000
Taxable Bond Series 2016A (weighted average coupon of 1.97%)	112,250
Taxable Bond Series 2016B (weighted average coupon of 1.99%)	83,510
Total taxable bonds	<u>235,760</u>

	<b>June 30, 2018</b>
Capital lease obligations and financing arrangements	185,452
Line of credit (weighted average coupon of 2.52%)	58,500
Taxable Term Loan (effective rate 2.58%)	114,827
Notes payable	5,282
Other	748
Deferred financing costs, net	(7,397)
Total long-term debt	<u>3,038,054</u>
Less amounts classified as current:	
Current portion of long-term debt	(175,679)
Long-term debt subject to short-term remarketing arrangements	(134,770)
Total amounts classified as current	<u>(310,449)</u>
Long-term debt, less current portion	<u><u>\$ 2,727,605</u></u>

Advocate's outstanding bonds were issued by the IFA and are secured by obligations issued under the Amended and Restated Master Trust Indenture dated as of September 1, 2011 and subsequently amended, with U.S. Bank National Association, as master trustee (the Advocate Master Indenture). Under the terms of the bond indentures and other arrangements, various amounts are to be on deposit with trustees and certain specified payments are required for bond redemption and interest payments. Advocate's Master Indenture and other debt agreements, including a bank credit agreement, also place restrictions on Advocate and require Advocate to maintain certain financial ratios.

Advocate's unsecured variable rate revenue bonds, Series 2008A-3 of \$42.8 million, Series 2008C-3B of \$22.0 million and Series 2011B of \$70.0 million, while subject to a long-term amortization period, may be put to Advocate at the option of the bondholders in connection with certain remarketing dates. To the extent that bondholders may, under the terms of the debt, put their bonds within a maximum of 12 months obligation in the accompanying interim unaudited condensed consolidated balance sheet. Management believes the likelihood of a material amount of bonds being put to the System is remote. However, to address this possibility, Advocate has taken steps to provide various sources of liquidity, including assessing alternate sources of financing, including lines of credit and/or unrestricted assets as a source of self-liquidity.

Advocate has standby bond purchase agreements with banks to provide liquidity support for substantially all of the Series 2008C Bonds. In the event of a failed remarketing of the supported Series 2008C Bonds upon its tender by an existing holder and subject to compliance with the terms of the standby bond purchase agreement, the standby bank would provide the funds for the purchase of such tendered bonds, and the System would be obligated to repay the bank for the funds it provided for such bond purchase (if such bond is not subsequently remarketed), with the first installment of such repayment commencing on the date one year and one day after the bank purchases the bond. The agreements expire as follows: \$49.8 million in August 2019; \$129.5 million in August 2020; and \$145.9 million in August 2021.

Advocate maintains an interest rate swap program on certain of its variable rate debt as described in Note 10. Interest Rate Swap Program.

Pursuant to loan agreements with WHEFA, Aurora system entities have borrowed the proceeds of the revenue bonds listed above from WHEFA (WHEFA Bonds). Aurora's obligation to repay WHEFA is secured by Obligations issued under a Master Trust Indenture (the Aurora Indenture). All outstanding debt under the Aurora Indenture represents joint and several obligations of the members of the Obligated Group and



are secured by a pledge of unrestricted receivables and a mortgage on Aurora St. Luke's Medical Center. Of the total fixed-rate WHEFA bonds, \$47.4 million is collateralized by bond insurance. Additionally, certain of the WHEFA variable-rate bonds are secured by letters of credit, as described below.

The WHEFA variable-rate demand bonds (VRDBs) are collateralized by \$454.1 million of irrevocable direct-pay letters of credit issued by commercial banks. Under certain circumstances, the VRDBs are subject to mandatory purchase by Aurora. The letters of credit provide interim financing to Aurora in the event Aurora is unable to remarket tendered bonds. The letters of credit expire at various dates through 2021 and have various repayment terms. For \$327.1 million of the letters of credit, principal payments are due quarterly, beginning the earlier of one year from the date of the advance or two months after the expiration date of the letter of credit and amortize over a three-year period, not to exceed three years from the letter of credit's stated expiration date. For the remaining \$127.0 million letters of credit, principal payments are due quarterly, beginning the earlier of one year from the date of the advance or two months after the expiration date of the letter of credit and shall amortize over a two-year period, not to exceed two years from the letter of credit's stated expiration date. At June 30, 2018, no draws were outstanding under the letters of credit. Aurora's repayment obligations to the commercial banks that provide the letters of credit are secured by Obligations issued under the Aurora Indenture.

Aurora has three series of taxable bonds outstanding, which were issued directly by Aurora and placed with multiple commercial banks (the Taxable Bonds). The outstanding principal amount of the Taxable Bonds is \$235.8 million as of June 30, 2018. The Series 2015A Taxable Bonds are subject to a mandatory tender on April 15, 2021. Aurora's repayment obligations for the Taxable Bonds are secured by Obligations issued under the Aurora Indenture.

At June 30, 2018, the System had lines of credit with banks aggregating to \$585.0 million. These lines of credit provide for various interest rates and payment terms and expire as follows: \$100.0 million in August 2018, \$60.0 million in December 2018, \$100.0 million in December 2019, \$275.0 million in August 2020, and \$50.0 million in September 2020. These lines of credit may be used to redeem bonded indebtedness, to pay costs related to such redemptions, for capital expenditures, or for general working capital purposes. As of June 30, 2018, there were three letters of credit issued under the line of credit totaling \$40.5 million was outstanding. At June 30, 2018, \$58.5 million was outstanding on these lines or letter of credits.

The System's interest paid, net of capitalized interest, amounted to \$31.6 million for the three months ended June 30, 2018. Additionally, the System capitalized interest of \$0.3 million for the three months ended June 30, 2018.

In August 2018, the System issued \$1,202.4 million of debt to refinance the WHEFA Bonds, the taxable bonds and the drawn portion of a line of credit and integrate Advocate and Aurora into a single Obligated Group. See discussion of this refinancing in Note 14. Subsequent Events.

## 9. INTEREST RATE SWAP PROGRAM

The System has interest rate-related derivative instruments to manage exposure of its variable rate debt instruments and does not enter into derivative instruments for any purpose other than risk management. By using derivative financial instruments to manage the risk of changes in interest rates, the System exposes itself to credit risk and market risk. Credit risk is the failure of the counterparty to perform under the terms of the derivative contracts. When the fair value of a derivative contract is positive, the counterparty owes the System, which creates credit risk for the System. When the fair value of a derivative contract is negative, the System owes the counterparty, and therefore, it does not possess credit risk. The System minimizes the credit risk in derivative instruments by entering into transactions that may require the counterparty to post collateral for the benefit of the System based on the credit rating of the counterparty and the fair value of the derivative contract. Market risk is the adverse effect on the value of a financial instrument that results from a change in interest rates. The market risk associated with interest rate changes is managed by establishing and monitoring parameters that limit the types and degree of market risk that may be undertaken. The System also mitigates risk through periodic reviews of its derivative positions in the context of its total blended cost of capital.

At June 30, 2018, the System maintains an interest rate swap program on its Series 2008C variable rate demand revenue bonds. These bonds expose the System to variability in interest payments due to changes in interest rates. The System believes that it is prudent to limit the variability of its interest payments. To meet this objective and to take advantage of low interest rates, the System entered into various interest rate swap agreements to manage fluctuations in cash flows resulting from interest rate risk. These swaps convert the variable rate cash flow exposure on the variable rate demand revenue bonds to synthetically fixed cash flows. The notional amount under each interest rate swap agreement is reduced over the term of the respective agreement to correspond with reductions in the principal outstanding under various bond series. The following is a summary of the outstanding positions under these interest rate swap agreements at June 30, 2018 (dollars in thousands):

<b>Bond Series</b>	<b>Notional Amount</b>	<b>Maturity Date</b>	<b>Rate Received</b>	<b>Rate Paid</b>
2008C-1	\$ 129,900	November 1, 2038	61.7% of LIBOR + 26bps	3.605%
2008C-2	108,425	November 1, 2038	61.7% of LIBOR + 26bps	3.605%
2008C-3	88,000	November 1, 2038	61.7% of LIBOR + 26bps	3.605%

The swaps are not designated as hedging instruments, and therefore, hedge accounting has not been applied. As such, unrealized changes in fair value of the swaps are included as a component of nonoperating income-net in the interim unaudited condensed consolidated statement of operations and changes in net assets. The net cash settlement payments, representing the realized changes in fair value of the swaps, are included as interest expense in the interim unaudited condensed consolidated statement of operations and changes in net assets.

The fair value of the interest rate swap agreements was \$61.3 million and no collateral was posted under these swap agreements as of June 30, 2018.

Amounts recorded in the interim unaudited condensed consolidated statement of operations and changes in net assets for the swap agreements are as follows (dollars in thousands):

	<b>June 30, 2018</b>
Net cash payments on interest rate swap agreements (interest expense)	\$ 1,745
Other nonoperating income, net (nonoperating)	\$ 5,060

The interest rate swap instruments contain provisions that require the System to maintain an investment grade credit rating on its tax-exempt bonds from certain major credit rating agencies. If the System's tax-exempt bonds were to fall below investment grade on the valuation date, it would be in violation of these provisions and the counterparty to the derivative instruments could request immediate payment or demand immediate and ongoing full overnight collateralization on derivative instruments in net liability positions.

## 10. EMPLOYEES' BENEFIT PLANS

The System maintains various employee benefit plans available to qualifying employees and retirees.

Advocate maintains defined benefit pension plans that cover substantially all its employees. The interim unaudited condensed consolidated balance sheet contained an asset related to the Advocate Health Care Network Pension Plan (Advocate Plan) of \$41.3 million at June 30, 2018. In addition, the interim unaudited condensed consolidated balance sheet contains a liability related to the Condell Health Network Retirement Plan (Condell Plan) of \$5.0 million at June 30, 2018. During the three months ended June 30, 2018, no contributions were made to the Advocate or Condell Plans.

The interim unaudited condensed consolidated balance sheet contains a liability related to the Aurora defined benefit pension plan (Aurora Plan) of \$94.5 million at June 30, 2018. The Aurora Plan covers substantially all of its employees, hired before January 1, 2013, with at least 1,000 hours of work in a calendar year. Benefits are based on years of service and the employees' final average earnings, as defined. The Aurora Plan is funded based on the amount calculated by the actuaries to meet the minimum Employee Retirement Income Security Act (ERISA) funding requirements. During the three months ended June 30, 2018, contributions of \$22.2 million were made to the Aurora Plan.

The System does not anticipate making additional contributions to the Advocate, Condell or Aurora pension plans in 2018.

Pension plan expense included in the interim unaudited condensed consolidated statement of operations and changes in net assets is as follows for the three months ended June 30, 2018 (dollars in thousands):

	<u>Advocate</u>	<u>Condell</u>	<u>Aurora</u>	<u>Total</u>
Service cost	\$ 13,760	\$ —	\$ —	\$ 13,760
Interest cost	8,777	625	15,125	24,527
Expected return on plan assets	(16,626)	(708)	(19,142)	(36,476)
Amortization of:				
Actuarial loss	1,324	420	—	1,744
Prior service cost	(996)	—	2,940	1,944
Net pension expense (income)	<u>\$ 6,239</u>	<u>\$ 337</u>	<u>\$ (1,077)</u>	<u>\$ 5,499</u>

The components of net period benefit costs other than the service cost component are included in other nonoperating income, net in the interim unaudited condensed consolidated statement of operations and changes in net assets.

Expected employee benefit payments from the Advocate and Condell Plan's assets are \$77.5 million in 2018; \$68.0 million in 2019; \$73.5 million in 2020; \$77.5 million in 2021; \$79.7 million in 2022 and \$416.3 million for the years 2023 through 2027.

Expected employee benefit payments from the Aurora Plan's assets are \$61.6 million in 2018; \$66.2 million in 2019; \$70.2 million in 2020; \$73.6 million in 2021; \$76.5 million in 2022; and \$418.7 million for the years 2023 through 2027.

The System's asset allocation and investment strategies are designed to earn returns on plan assets consistent with a reasonable and prudent level of risk. Investments are diversified across classes, economic sectors and manager style to minimize the risk of loss. The System utilizes investment managers specializing in each asset category and, where appropriate, provides the investment manager with specific guidelines that include allowable and/or prohibited investment types. The System regularly monitors manager performance and compliance with investment guidelines.

The System's target and actual pension asset allocations for the Plans are as follows:

<b>Asset Category - Advocate Plan</b>	<b>June 30, 2018</b>	
	<b>Target</b>	<b>Actual</b>
Domestic and International equity securities	35%	34%
Alternative investments	45%	48%
Cash and fixed income securities	20%	18%
Total	100%	100%

<b>Asset Category - Condell Plan</b>	<b>June 30, 2018</b>	
	<b>Target</b>	<b>Actual</b>
Domestic and International equity securities	15%	15%
Cash and fixed income securities	85%	85%
Total	100%	100%

<b>Asset Category - Aurora Plan</b>	<b>June 30, 2018</b>	
	<b>Target</b>	<b>Actual</b>
Equity securities	33%	32%
Fixed-income securities	64%	59%
Real estate	3%	3%
Cash and cash equivalents	—%	6%
Total	100%	100%

Assumptions used to determine benefit obligations are as follows:

	<b>June 30, 2018</b>
Discount rate - Advocate and Condell Plans	3.60%
Discount rate - Aurora Plan	3.79%
Assumed rate of return on assets - Advocate Plan	7.00%
Assumed rate of return on assets - Condell Plan	5.00%
Assumed rate of return on assets - Aurora Plan	5.50%

The assumed rate of return on Advocate and Condell Plans assets is based on historical and projected rates of return for asset classes in which the portfolio is invested. The expected return for each asset class was then weighted based on the target asset allocation to develop the overall expected rate of return on assets for the portfolio. The Aurora Plan expected long-term rate of return is based on the asset allocation of the total portfolio considering capital return assumptions from various sources.

In addition to these Plans, the System sponsors various defined contribution plans for its employees. Contributions to these plans, which are included in salaries, wages and benefits expense in the interim unaudited condensed consolidated statement of operations and changes in net assets, were \$48.4 million for the three months ended June 30, 2018.

## 11. GENERAL AND PROFESSIONAL LIABILITY INSURANCE

Commercial insurance companies have issued policies covering Aurora's primary professional, general and managed care errors and omission liability risks. Aurora's professional and general liability insurance is on an occurrence basis, while managed care errors and omissions liability risks are written on a claims-made basis.

Aurora's hospitals, clinics, surgery centers, physicians and certified registered nurse anesthetist providers that provide health care in Wisconsin are qualified health care providers as defined by Wisconsin state statute, and have separate professional liability limits of \$1.0 million per claim and \$3.0 million annual aggregate applied to each qualified provider. Losses in excess of these amounts are fully covered through mandatory participation in the State of Wisconsin Injured Patients and Families Compensation Fund (the Fund).

Aurora also has professional liability coverage for its providers and affiliates that do not qualify for the Fund coverage, as well as general liability for all of its entities. These coverages provide a number of shared professional liability limits and shared general liability limits totaling \$2.0 million per occurrence and \$4.0 million annual aggregate for most providers. Losses in excess of these amounts are covered by Aurora's umbrella/excess insurance.

The professional, general and managed care liabilities discussed above have been ceded back to Aurora Liability Assurance, Ltd. (ALA), a wholly-owned subsidiary of Aurora, through reinsurance agreements. Independent actuaries evaluate the required provision for outstanding losses related to these risks. At June 30, 2018 Aurora has recorded a liability for outstanding losses, including incurred but not reported, discounted at 4.0%, totaling \$32.9 million. This liability is presented within the current portion of accrued insurance and claim costs and accrued insurance and claims cost, less current portion in the accompanying interim unaudited condensed consolidated balance sheet. In the opinion of management, the ultimate disposition of claims incurred to date will not have a material adverse effect on the System's consolidated financial position or results of operations. ALA maintains a reinsurance trust account, which in total represents security required by the reinsurance agreement between ALA and the insurance companies. At June 30, 2018, assets held in the trust account were \$46.8 million.

Advocate is self-insured for substantially all general and professional liability risks. The self-insurance programs combine various levels of self-insured retention with excess commercial insurance coverage. In addition, various umbrella insurance policies have been purchased to provide coverage in excess of the self-insured limits. Revocable trust funds, administered by a trustee and a captive insurance company, have been established for the self-insurance programs. Actuarial consultants have been retained to determine the estimated cost of claims, as well as to determine the amount to fund into the irrevocable trust and captive insurance company.

The estimated cost of claims is actuarially determined based on past experience, as well as other considerations, including the nature of each claim or incident and relevant trend factors. Accrued insurance liabilities and contributions to the trust were determined using a discount rate of 3.00% as of June 30, 2018. Accrued insurance liabilities for the Advocate's captive insurance company were determined using a discount rate of 3.00% for 2018.

The System entities are defendants in certain litigation related to professional and general liability risks, and other matters. Although the outcome of the litigations cannot be determined with certainty, management believes, after consultation with legal counsel, that the ultimate resolution of the litigations will not have a material adverse effect on the System's operations or financial condition.

## **12. LEGAL, REGULATORY AND OTHER CONTINGENCIES**

The health care industry is subject to significant regulatory requirements of federal, state and local governmental agencies and independent professional organizations and accrediting bodies, technological advances and changes in treatment modes, various competitive factors and changes in third-party reimbursement programs. Certain of these factors include: licensing, surveys, audits and investigations; privacy laws; “Fraud and Abuse” laws and regulations; the Federal False Claims Act; restrictions on referrals; environmental laws and regulations; and other Federal, state and local laws and regulations.

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. During the last few years, due to nationwide investigations by governmental agencies, various health care organizations have received requests for information and notices regarding alleged noncompliance with those laws and regulations, which, in some instances, have resulted in organizations entering into significant settlement agreements. Compliance with such laws and regulations may also be subject to future government review and interpretation, as well as significant regulatory action, including fines, penalties, exclusion from the Medicare and Medicaid programs and revocation of federal or state tax-exempt status. Moreover, the System expects that the level of review and audit to which it and other health care providers are subject will increase.

Various federal and state agencies have initiated investigations, which are in various stages of discovery, relating to reimbursement, billing practices and other matters of the System. There can be no assurance that regulatory authorities will not challenge the System’s compliance with these laws and regulations, and it is not possible to determine the impact, if any, such claims or penalties would have on the System. Thus, there is a reasonable possibility that recorded amounts will change by a material amount in the near term. To foster compliance with applicable laws and regulations, the System maintains a compliance program designed to detect and correct potential violations of laws and regulations related to its programs.

## **13. AFFILIATION**

On April 1, 2018, Advocate Aurora Health, Inc., became the sole corporate member of Advocate Health Care Network and Aurora Health Care, Inc. The System was formed in furtherance of the parties’ common and unifying charitable health care mission to promote and improve the quality and expand the scope and accessibility of affordable health care and health-care related services for the communities they serve.

The Affiliation was accounted for as a merger in accordance with Financial Accounting Standards Board, Accounting Standards Codification 958-805, Not-for-Profit Entities Business Combinations. The System has accounted for the merger by applying the carryover method.

The proforma financial statements included within this quarterly report were prepared on a consolidated basis utilizing accounting records of Advocate and Aurora as if the System had been operating as a combined company for the periods presented. These financial statements have been prepared in accordance with GAAP. The System's proforma assets, liabilities, revenues, and expenses have been adjusted to include a previously non-consolidated lab joint venture as well as associated eliminations of activity and balances due between Advocate and Aurora. Additionally, certain accounting policies have been adjusted to align Advocate and Aurora within the proforma statements presented. Management believes the assumptions underlying the proforma financial statements presented, including the assumptions regarding the elimination of inter-company activity and accounting policy changes are reasonable. Nevertheless, the proforma statements may not reflect the results of operations and financial position had the System been a combined company during the periods presented and is not intended to project the System's results of operations for any future periods.

**ADVOCATE AURORA HEALTH, INC. AND ITS AFFILIATES AND SUBSIDIARIES**  
**PROFORMA CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS**  
(Dollars in thousands)

	<b>Six Months Ended June 30, 2018</b>
REVENUE:	
Net patient service revenue	\$ 4,902,877
Capitation revenue	653,771
Other operating revenue	381,690
Total revenue	5,938,338
EXPENSES:	
Salaries, wages and benefits	3,216,057
Supplies and purchased services	1,421,165
Contract medical services	296,187
Depreciation and amortization	270,877
Interest	53,346
Other	425,925
Total expenses	5,683,557
OPERATING INCOME BEFORE NONRECURRING LOSSES	254,781
Nonrecurring losses	33,995
OPERATING INCOME	220,786
NONOPERATING INCOME:	
Investment income, net	35,641
Other nonoperating income, net	25,025
Total nonoperating income, net	60,666
EXCESS OF REVENUE OVER EXPENSES	281,452
Less noncontrolling interest	(22,880)
EXCESS OF REVENUE OVER EXPENSES - attributable to controlling interest	\$ 258,572

**SUMMARY OF CHANGES IN NET ASSETS**  
(Dollars in thousands)

Increase in unrestricted net assets - attributable to controlling interest	\$ 153,548
Increase in unrestricted net assets - noncontrolling interest	\$ 5,759
Decrease in temporarily restricted net assets	\$ (3,919)
Increase in permanently restricted net assets	\$ 70

**ADVOCATE AURORA HEALTH, INC. AND ITS AFFILIATES AND SUBSIDIARIES**  
**PROFORMA CONDENSED CONSOLIDATED BALANCE SHEET**  
(Dollars in thousands)

	April 1, 2018				
	Aurora	Advocate	A2CL	Eliminations	Consolidated
<b>ASSETS</b>					
CURRENT ASSETS:					
Cash and cash equivalents	\$ 171,402	\$ 235,425	\$ 1,278	\$ —	\$ 408,105
Investments	1,429,004	21,099	—	—	1,450,103
Assets limited as to use	4,523	94,224	—	—	98,747
Patient accounts receivable	744,668	726,045	—	—	1,470,713
Other current assets	193,669	348,921	12,317	(21,510)	533,397
Total current assets	2,543,266	1,425,714	13,595	(21,510)	3,961,065
Assets limited as to use	308,377	6,176,657	—	—	6,485,034
Property and equipment, net	2,445,764	2,987,734	—	—	5,433,498
Total other assets	273,787	498,605	1,579	(10,075)	763,896
TOTAL	5,571,194	11,088,710	15,174	(31,585)	16,643,493
<b>LIABILITIES AND NET ASSETS</b>					
CURRENT LIABILITIES:					
Current portion of long term-debt	136,239	120,901	—	—	257,140
Accounts payable and accrued liabilities	623,687	829,635	18,127	(21,510)	1,449,939
Other current liabilities	31,653	425,468	—	—	457,121
Total current liabilities	791,579	1,376,004	18,127	(21,510)	2,164,200
NONCURRENT LIABILITIES:					
Long-term debt, less current portion	1,266,070	1,539,105	—	—	2,805,175
Accrued Insurance and claims costs, less current portion	27,381	636,856	—	—	664,237
Other long-term liabilities	382,919	359,597	—	(13,028)	729,488
Total noncurrent liabilities	1,676,370	2,535,558	—	(13,028)	4,198,900
Total liabilities	2,467,949	3,911,562	18,127	(34,538)	6,363,100
NET ASSETS:					
Unrestricted:					
Controlling interest	2,934,281	7,009,528	(2,953)	2,953	9,943,809
Noncontrolling interest in subsidiaries	104,168	570	—	—	104,738
Total unrestricted net assets	3,038,449	7,010,098	(2,953)	2,953	10,048,547
Temporarily restricted	45,827	113,440	—	—	159,267
Permanently restricted	18,969	53,610	—	—	72,579
Total net assets	3,103,245	7,177,148	(2,953)	2,953	10,280,393
TOTAL	\$ 5,571,194	\$ 11,088,710	\$ 15,174	\$ (31,585)	\$ 16,643,493



#### **14. SUBSEQUENT EVENTS**

The System evaluated events and transactions subsequent to June 30, 2018 through August 28, 2018, the date of financial statement issuance.

In August 2018, the System issued \$1,202.4 million of debt to refinance the WHEFA Bonds, the taxable bonds and the drawn portion of a line of credit and integrate Advocate and Aurora into a single Obligated Group. The structure of the new debt is \$714.5 million of taxable fixed rate bonds, \$97.5 million of tax-exempt fixed rate bonds, \$191.0 million of tax-exempt long-term rate bonds and \$199.4 million of tax exempt floating rate notes.

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## **MANAGEMENT’S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL POSITION**

This quarterly report includes the interim unaudited condensed consolidated financial statements and analysis for Advocate Aurora Health, Inc., a Delaware nonprofit corporation (the “Parent Corporation”), and its affiliates and subsidiaries. References to "the System", "we", "our", or "us" in this document are to the Parent Corporation and all of the affiliates and subsidiaries consolidated with it pursuant to accounting principles generally accepted in the United States of America (GAAP). References to the Parent Corporation are references only to the Parent corporation, and should not be read to include any of the Parent Corporation’s affiliates and subsidiaries. References to "Legacy systems" in this document refers to Advocate Health Care Network and Subsidiaries ("Advocate") and Aurora Health Care, Inc., and Subsidiaries ("Aurora") either individually or collectively.

The financial information should be read together with our interim unaudited condensed consolidated financial statements and related notes included elsewhere in this quarterly report, as well as the audited consolidated financial statements of Advocate and Aurora as of and for the years ended December 31, 2017 and 2016, the audited consolidated financial statements are available from the Municipal Securities Rulemaking Board (the “MSRB”) on its Electronic Municipal Market Access (“EMMA”) system, found at <http://emma.msrb.org>. Additional information can be found on the investor relations section of the System's website at <https://www.advocateaurorahealth.org/investor-relations>.

Certain statements included in this quarterly report constitute forward-looking statements that involve risks and uncertainties. Actual results may differ significantly from the results discussed in the forward-looking statements as a result of known and unknown risks, uncertainties and other factors which may cause actual results, performance or achievements described to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. We do not plan to issue any updates or revisions to those forward-looking statements if or when the expectations, or events, conditions or circumstances on which such statements are based occur.

**ADVOCATE AURORA HEALTH, INC. AND ITS AFFILIATES AND SUBSIDIARIES**  
**KEY FINANCIAL RATIOS**  
**FOR THE PERIOD ENDED JUNE 30, 2018**

	Three Months Ended,		Six Months Ended,	
	June 2018	June 2017 <sup>(A)</sup>	June 2018 <sup>(A)</sup>	June 2017 <sup>(A)</sup>
<b>Profitability:</b>				
Operating margin <sup>(1)</sup>	4.1%	4.7%	4.3%	4.8%
Operating cash flow margin <sup>(2)</sup>	9.5%	10.2%	9.8%	10.3%
Excess Margin <sup>(3)</sup>	5.2%	9.8%	4.7%	11.0%
EBIDA margin <sup>(4)</sup>	10.7%	15.8%	10.2%	17.2%

	As of June 30, 2018	As of April 1, 2018 <sup>(A)</sup>
<b>Leverage and Liquidity:</b>		
Debt to capitalization <sup>(5)</sup>	22.9%	23.4%
Cash to debt <sup>(6)</sup>	247.7%	243.6%
Days cash on hand <sup>(7)</sup>	247.4	255.4

<sup>(A)</sup> - See discussion of the preparation of proforma statements in Note 13. Affiliation.

**Profitability:**

<sup>(1)</sup> Operating income before nonrecurring losses/Total revenue

<sup>(2)</sup> (Operating income before nonrecurring losses + Interest + Depreciation and amortization)/Total revenue

<sup>(3)</sup> Excess of revenue over expenses/(Total revenue + Total nonoperating income, net)

<sup>(4)</sup> (Excess of revenue over expenses + Interest + Depreciation and amortization)/Total revenue

**Liquidity:**

<sup>(5)</sup> (Current portion of long-term debt + Long-term debt subject to short-term remarketing + Long-term debt, less current portion)/  
(Current portion of long-term debt + Long-term debt subject to short-term remarketing + Long-term debt, less current portion + Total  
unrestricted net assets)

<sup>(6)</sup> Unrestricted cash and investments / (Current portion of long-term debt + Long-term debt subject to short-term remarketing + Long-  
term debt, less current portion)

<sup>(7)</sup> Unrestricted cash and investments/(Total operating expenses before nonrecurring losses - Depreciation and amortization)/ days in  
period). The days cash on hand ratio is calculated from expenses for the three months ended June 30, 2018 and April 1, 2018.

**ADVOCATE AURORA HEALTH, INC. AND ITS AFFILIATES AND SUBSIDIARIES**  
**HISTORICAL UTILIZATION**

	<b>Three Months Ended June 30, 2018</b>	<b>Proforma Three Months Ended June 30, 2017</b>	<b>Change</b>	<b>% Change</b>
Discharges <sup>(1)</sup>	68,506	68,890	(384)	(0.6)%
Observation Cases	24,658	23,939	719	3.0 %
Outpatient Visits	1,136,154	1,105,021	31,133	2.8 %
Physician Visits	2,301,655	2,221,242	80,413	3.6 %
Home Care Admissions	13,045	12,040	1,005	8.3 %
Capitated Member Lives <sup>(2)</sup>	319,331	343,632	(24,301)	(7.1)%
	<b>Proforma Six Months Ended June 30, 2018</b>	<b>Proforma Six Months Ended June 30, 2017</b>	<b>Change</b>	<b>% Change</b>
Discharges <sup>(1)</sup>	85,578	85,371	207	0.2 %
Observation Cases	27,679	28,755	(1,076)	(3.7)%
Outpatient Visits	984,514	971,334	13,180	1.4 %
Physician Visits	2,057,067	1,945,358	111,709	5.7 %
Home Care Admissions	14,169	13,368	801	6.0 %

<sup>(1)</sup> Includes Legacy Advocate transitional care

<sup>(2)</sup> As of the date set forth in the column header

**ADVOCATE AURORA HEALTH, INC. AND ITS AFFILIATES AND SUBSIDIARIES**  
**PROFORMA CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Dollars in thousands)

	<b>Three Months Ended June 30, 2018</b>	<b>Three Months Ended June 30, 2017 <sup>(A)</sup></b>
REVENUE:		
Net patient service revenue	\$ 2,462,661	\$ 2,370,370
Capitation revenue	332,803	326,517
Other revenue	200,301	198,515
Total revenue	2,995,765	2,895,402
EXPENSES:		
Salaries, wages and benefits	1,613,838	1,563,141
Supplies and purchased services	731,102	683,008
Contract medical services	153,770	136,200
Depreciation and amortization	136,241	129,913
Interest	26,864	28,853
Other	212,164	217,938
Total expenses	2,873,979	2,759,053
OPERATING INCOME BEFORE NONRECURRING LOSSES	121,786	136,349
Nonrecurring losses	14,545	—
OPERATING INCOME	107,241	136,349
NONOPERATING INCOME:		
Investment income, net	44,796	160,363
Other nonoperating income, net	6,667	2,140
Total nonoperating income, net	51,463	162,503
EXCESS OF REVENUE OVER EXPENSES	158,704	298,852
Less noncontrolling interest	(12,451)	(12,162)
EXCESS OF REVENUE OVER EXPENSES - attributable to controlling interest	\$ 146,253	\$ 286,690

<sup>(A)</sup> See discussion of the preparation of proforma statements in Note 13. Affiliation.

**ADVOCATE AURORA HEALTH, INC. AND ITS AFFILIATES AND SUBSIDIARIES**  
**PROFORMA CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Dollars in thousands)

	<b>Six Months Ended June 30, 2018 <sup>(A)</sup></b>	<b>Six Months Ended June 30, 2017 <sup>(A)</sup></b>
REVENUE:		
Net patient service revenue	\$ 4,902,877	\$ 4,724,671
Capitation revenue	653,771	645,071
Other revenue	381,690	395,851
Total revenue	5,938,338	5,765,593
EXPENSES:		
Salaries, wages and benefits	3,216,057	3,115,185
Supplies and purchased services	1,421,165	1,340,011
Contract medical services	296,187	279,584
Depreciation and amortization	270,877	257,411
Interest	53,346	57,145
Other	425,925	439,567
Total expenses	5,683,557	5,488,903
OPERATING INCOME BEFORE NONRECURRING LOSSES	254,781	276,690
Nonrecurring losses	33,995	—
OPERATING INCOME	220,786	276,690
NONOPERATING INCOME:		
Investment income, net	35,641	398,417
Other nonoperating income, net	25,025	4,695
Total nonoperating income, net	60,666	403,112
EXCESS OF REVENUE OVER EXPENSES	281,452	679,802
Less noncontrolling interest	(22,880)	(24,123)
EXCESS OF REVENUE OVER EXPENSES - attributable to controlling interest	\$ 258,572	\$ 655,679

<sup>(A)</sup> See discussion of the preparation of proforma statements in Note 13. Affiliation.

## ANALYSIS OF RESULTS OF OPERATIONS

The management discussion and analysis section refers to the proforma condensed consolidated statements of operations. The proforma information should not be construed to accurately reflect what the actual results would have been had the affiliation been consummated as of the comparative periods presented in 2017.

### Results of Operations – Three Months Ended June 30, 2018 Compared to Three Months Ended June 30, 2017

Operating income before nonrecurring losses was \$121.8 million for the three months ended June 30, 2018, resulting in an operating margin of 4.1%, compared to operating income of \$136.3 million for the three months ended June 30, 2017, resulting in an operating margin of 4.7%. Nonrecurring losses of \$14.5 million for the three months ended June 30, 2018 consisted of costs to implement an electronic medical records system and costs incurred in connection with the Affiliation.

Net patient service revenue increased \$92.3 million (3.9%) in the three months ended June 30, 2018, compared to the same period in the prior year. Net patient service revenue increased primarily due to an increase in volumes across most service lines excluding inpatient volumes and price increases over the comparative period.

Salaries, wages and benefits increased \$50.7 million (3.2%) in the three months ended June 30, 2018, compared to the same period in the prior year. The increase in salaries, wages and benefits is due to an increase in staffing related to increased outpatient and physician visits. Salaries, wages and benefit as a percent of net patient service revenue and capitation revenue was 57.7% compared to 58.0% in the prior year.

Supplies and purchased services increased \$48.1 million (7.0%) in the three months ended June 30, 2018, compared to the same period in the prior year primarily due to an increase in volumes. Supplies and purchased services expense as a percent of total revenue less capitation revenue increased from 26.6% to 27.5%, this is primarily due to the mix of services performed.

Contract medical services increased \$17.6 million (12.9%) in the three months ended June 30, 2018, compared to the same period in the prior year. This increase is due to increased utilization and acuity of capitated members, primarily related to Medicare Advantage risk plans.

Nonoperating income decreased \$111.0 million for the three months ended June 30, 2018, compared to the same period in the prior year, primarily due to deterioration in financial markets. The System yielded an investment return of approximately 0.7% on its investments including investment income, net which is classified within operations and changes in restricted net assets for the three months ended June 30, 2018, compared to 2.3% for the three months ended June 30, 2017. See disclosure of the composition of investment income, net within Note 4. Investments.

Overall, the System reported an excess of revenue over expenses of \$158.7 million for the three months ended June 30, 2018 compared to \$298.9 million for the three months ended, June 30, 2017.

## Results of Operations – Six Months Ended June 30, 2018 Compared to Six Months Ended June 30, 2017

Operating income before nonrecurring losses was \$254.8 million for the six months ended June 30, 2018, resulting in an operating margin of 4.3%, compared to operating income of \$276.7 million for the six months ended June 30, 2017, resulting in an operating margin of 4.8%. Nonrecurring losses of \$34.0 million for the six months ended June 30, 2018 consisted of costs to implement an electronic medical records system and costs incurred in connection with the Affiliation.

Net patient service revenue increased \$178.2 million (3.8%) in the six months ended June 30, 2018, compared to the same period in the prior year. Net patient service revenue increased primarily due to an increase in volumes across most service lines excluding observation cases and price increases over the comparative period.

Salaries, wages and benefits increased \$100.9 million (3.2%) in the six months ended June 30, 2018, compared to the same period in the prior year. The increase in salaries, wages and benefits is due to an increase in staffing related to increased outpatient and physician visits. Salaries, wages and benefit as a percent of net patient service revenue and capitation revenue was 57.9% compared to 58.0% in the prior year.

Supplies and purchased services increased \$81.2 million (6.1%) in the six months ended June 30, 2018, compared to the same period in the prior year primarily due to an increase in volumes. Supplies and purchased services expense as a percent of total revenue increased from 26.2% to 26.9%, this is primarily due to the mix of services performed.

Nonoperating income decreased \$342.4 million for the six months ended June 30, 2018, compared to the same period in the prior year, primarily due to deterioration in financial markets which caused investment income to decrease \$362.8 million. Other nonoperating income increased \$20.3 million this increase is primarily due to the realization of deferred gains of \$5.7 million associated with the purchase of properties previously accounted for as capital leases and other financing arrangements and an increase in the fair value of swaps due to market conditions of \$13.8 million.

Overall, the System reported an excess of revenue over expenses of \$281.5 million for the six months ended June 30, 2018 compared to \$298.9 million for the six months ended, June 30, 2017.



## ANALYSIS OF FINANCIAL CONDITION

### Liquidity – Cash and Investments

It is contemplated that the investment assets of the Legacy Advocate System and the Legacy Aurora System will be consolidated into a single investment portfolio by the end of calendar year 2018. As contemplated, the investments are expected to be combined at the asset allocation levels described below for the Legacy Advocate System and continue to be managed by external investment professionals under the guidelines set out in an investment policy statement adopted by the System's Board. The combined investment portfolio will be overseen by an Investment Subcommittee of the Finance Committee of the Parent Board. Until such consolidation is completed, the System's investments will continue to be managed by their existing external investment professionals in compliance with each Legacy System's existing investment policies.

The System's investment program's target asset allocation, excluding cash and cash equivalents maintained for operating purposes, provides for a commitment to equity securities (30%), fixed income investments (20%), and select alternative investment classes (50%). For each of the above categories, the policy establishes allocation targets, with specific ranges for each asset class, among the following investment styles: 12% domestic equities; 18% international equities; 20% fixed income; 10% private equity; 25% hedge funds; and 15% real assets. Further, limitations are placed on investment managers as to the overall amount that can be invested in one issuer (except for U.S. government obligations and its agencies) or economic sector.

The following table sets forth the allocation of the Aurora's cash and cash equivalents, investments, and assets whose use is limited or restricted at June 30, 2018 (dollars in thousands):

	<b>June 30, 2018</b>	
Cash and cash equivalents	\$ 144,950	7.5%
Fixed-income securities	1,092,888	56.7%
Domestic and international equity securities	652,869	33.9%
Real estate investments	<u>35,729</u>	<u>1.9%</u>
Total	\$ 1,926,436	100.0%

The following table sets forth the allocation of the Advocate's cash and cash equivalents, investments, and assets whose use is limited or restricted at June 30, 2018 (dollars in thousands):

	<b>June 30, 2018</b>	
Cash and short term investments	\$ 399,695	6.1%
Corporate bonds	364,161	5.5%
US governmental obligations (government issues)	413,523	6.3%
Non-Governmental fixed income obligations	25,375	0.4%
Bond mutual funds	455,513	6.9%
Hedge funds	2,180,265	33.1%
Private equity	978,965	14.9%
Equity securities (common stock)	942,131	14.3%
Equity mutual funds	<u>820,739</u>	<u>12.5%</u>
Total	\$ 6,580,367	100.0%

The overall yields on the System's investment portfolio for the three months ended June 30, 2018 and 2017 were 0.7% and 2.3%, respectively.

Investment income (including both realized and unrealized gains on investments) significantly impacts the System's financial results. Market fluctuations have affected and will likely continue to materially affect the value of those investments and those fluctuations may be and historically have been material. Reduction in investment income, or realized and unrealized losses, and the market value of its investments may have a negative impact on the System's financial condition, including its ability to provide its own liquidity for variable rate debt or to fund capital expenditures from cash and investments.

## Days Cash on Hand

Days cash on hand before nonrecurring losses was 247.4 for the three months ended June 30, 2018 compared to 244.5 for the proforma three months ended June 30, 2017. The increase in days cash on hand is due to the System's continued strong cash flow from operations.

## Indebtedness

Master Indenture Obligations: In August 2018, the System issued \$1,202.4 million in aggregate principal amount of bonds (the Series 2018 Bonds) to refinance the WHEFA Bonds, the Taxable Bonds and the drawn portion of a line described in Note 8. Long-term debt. As a result of that refinancing, the existing Aurora Master Trust Indenture was discharged, and the Series 2018 Bonds, as well as Advocate's outstanding bonds and certain other obligations to lenders, banks and swap counterparties all secured under the Amended and Restated Master Trust Indenture dated as of September 1, 2011, with the Members of the Obligated Group and U.S. Bank National Association, as master trustee (the Advocate Aurora Master Indenture).

Under the terms of the bond indentures and other arrangements, various amounts are to be on deposit with trustees, and certain specified payments are required for bond redemption and interest payments. The Advocate Aurora Master Indenture and other debt agreements, including bank credit agreements, also place restrictions on the System to maintain certain financial ratios. Each of the bank agreements require various reporting, operating and financial covenants to be maintained. These covenants may be waived, modified or amended by the related bank in its sole discretion and without notice to or consent by any bond trustee, the Master Trustee or the holders of any outstanding bonds. Violation of any such covenants may result in an Event of Default under the Advocate Aurora Master Indenture, which could result in acceleration of all Obligations issued under the Advocate Aurora Master Indenture.

The System's total long-term debt at June 30, 2018 was as follows (dollars in thousands):

	<b>June 30, 2018</b>
Total revenue bonds	\$ 2,444,882
Taxable bonds	235,760
Capital lease obligations and financing arrangements	185,452
Line of credit	58,500
Taxable term note	114,827
Notes Payable	5,282
Other	748
Deferred financing costs — net	(7,397)
Total long-term debt	<u>\$ 3,038,054</u>

Standby Bond Purchase Agreements ("SBPA"): At June 30, 2018, Advocate was a party to four SBPAs with three banks to provide liquidity support for the four subseries of the Series 2008C Bonds (other than the \$22.0 million 2008 C-3B Bonds, which were converted to long-term rate bonds in 2009) in the event of a failed remarketing of any such subseries of the Series 2008C Bonds. The termination dates of the SBPAs are as follows:

<b>Subseries</b>	<b>Par (dollars in thousands)</b>	<b>Expiration</b>
2008C-1	\$ 129,500	8/31/2020
2008C-2A	49,800	8/1/2019
2008C-2B	58,200	8/15/2021
2008C-3A	87,700	8/15/2021
Total	<u>\$ 325,200</u>	

In the event any Bank Bonds are not remarketed within one year from the date they are purchased by a bank pursuant to an SBPA, Advocate has agreed to cause such Bank Bonds to be redeemed pursuant to the related bond indenture such that the unpaid principal balance of all outstanding Bank Bonds shall amortize in sixteen approximately equal quarterly installments, with the first installment commencing on the date that is one year and one day after the date on which such Series 2008C Bond became a Bank Bond, and the final installment payable on the date that is five years from the date on which such Series 2008C Bond became a Bank Bond. At June 30, 2018 there were no Bank Bonds outstanding.

Variable Rate Demand Bonds (VRDBs): At June 30, 2018, Aurora had outstanding \$437.1 million VRDBs. The VRDBs bear interest at variable rates (currently in daily, weekly, or Unit Pricing interest rate modes) and are subject to optional tender for purchase by their holders. At June 30, 2018, all of the VRDBs are secured by letters of credit issued by commercial banks (the Letters of Credit). Subject to certain requirements in the related Reimbursement Agreements, the Letters of Credit may be drawn on to pay the purchase price of the VRDBs in the event they are not remarketed. The Letters of Credit expire at various dates through 2021 (as set forth in the table below) and have various repayment terms. Principal payments for any advances under each of the Letters of Credit begin the earlier of one year from the date of the advance and two months after the expiration date of the Letter of Credit. The principal payments for any advance under the Letters of Credit amortize over a two or three-year period. Each Letter of Credit is subject to extension of its expiration date at the sole discretion of the related commercial bank.

<b>Bank</b>	<b>Par (dollars in thousands)</b>	<b>Expiration</b>
Bank of America	\$ 108,080	1/31/2019
J.P. Morgan	50,822	9/28/2020
J.P. Morgan	84,384	9/28/2020
J.P. Morgan	83,825	9/28/2020
Bank of Montreal	36,544	2/7/2021
Bank of Montreal	36,544	2/7/2021
Bank of Montreal	53,918	2/7/2021
Total	<u>\$ 454,117</u>	

The VRDBs were refinanced with the issuance of the 2018 Series Bonds as described in Note 14. Subsequent Events.

Covenant Agreements (CAs): At June 30, 2018, Advocate is party to additional CAs with a bank, related to the \$50.0 million Series 2011C Bonds and \$50.0 million Series 2011D Bonds issued in September 2011 and purchased by the bank. The Series 2011C Bonds and Series 2011D bonds currently bear interest at an indexed rate until September 3, 2024. At the end of their initial periods, the Series 2011C Bonds and the Series 2011D Bonds will

be subject to mandatory tender, unless waived by the holders thereof, and Advocate presently anticipates that the Series 2011C Bonds and Series 2011D Bonds will be remarketed to new holders in one of the interest rate modes available under the related bond indenture. In the event the Series 2011C Bonds or the Series 2011D Bonds are not remarketed on their respective mandatory tender dates, then, as long as no default or event of default (as defined in the CAs) has occurred and is continuing, the Series 2011C Bonds or Series 2011D Bonds, as applicable, may either be repaid over a three-year period or remarketed during that time.

Long-term Rate Bonds: At June 30, 2018, Advocate's Series 2003A and the Series 2003C Bonds and the Series 2008A-1, Series 2008A-2 and Series 2008A-3 Bonds were originally issued as long-term rate bonds with stated sinking fund redemptions through 2022 and 2030, respectively. The Series 2003A Bonds and Series 2003C Bonds have been remarketed for new long-term rate periods that extend to their maturity dates both of which is November 15, 2022. The Series 2008A-1, Series 2008A-2, Series 2008A-3 Bonds and the Series 2008C-3B Bonds, bear interest at long-term rates for a particular interest rate period and are subject to mandatory tender at the end of each particular interest rate period.

The following table summarizes the next scheduled mandatory tender dates for these long-term rate bonds as of June 30, 2018. In the event these bonds are not remarketed upon mandatory tender at the end of their current interest rate period, management anticipates utilizing marketable unrestricted investments and/or available lines of credit to meet the purchase obligations.

<b>Series</b>	<b>Principal Amount (dollars in thousands)</b>	<b>Next Mandatory Tender Date</b>
Series 2008C-3B	\$ 22,000	7/30/2018 *
Series 2008A-3	42,800	5/1/2019
Series 2008A-1	42,000	1/15/2020
Series 2008A-2	35,500	2/12/2020
Total	<u>\$ 142,300</u>	

\* Retired with cash on the mandatory tender date

The Series 2008C-3B Bonds and the Series 2008A-3 Bonds were classified as current liabilities as of June 30, 2018 in the interim unaudited condensed consolidated balance sheet because these bonds are subject to mandatory tender on a date that is within one year of the balance sheet date.

Windows Variable Rate Bonds: Advocate's Series 2011B Bonds bear interest at Windows Interest Rates (the "Windows Variable Rate Bonds") and are subject to optional and mandatory tender for purchase. The Windows Variable Rate Bonds are not supported by any external dedicated liquidity facility. Holders of Windows Variable Rate Bonds have a right to optionally tender their Bonds for purchase. If the tendered Windows Variable Rate Bonds are not successfully remarketed within the 30-day period that follows the date that notice of such optional tender is received by the Remarketing Agent (the "Remarketing Window"), then all Windows Variable Rate Bonds are required to be purchased on the day that is 210 days after notice of such optional tender is received by the Remarketing Agent (the "Windows Mandatory Tender Date"). The period from the end of the Remarketing Window until the Windows Mandatory Tender Date (initially, 18 days) is referred to as the "Funding Window". During the Funding Window, Advocate expects that it would analyze the then current market conditions, availability and relative cost of any refinancing or restructuring alternatives for those Windows Variable Rate Bonds that are required to be purchased on the Windows Mandatory Tender Date (including, without limitation, conversion of those bonds to another interest mode or the refinancing or repayment of those bonds). The Windows Variable Rate Bonds are classified as current liabilities in the interim unaudited condensed consolidated balance sheet because these bonds may be subject to tender on a date that is within one year of the balance sheet date.

Taxable Bonds: At June 30, 2018, Aurora had outstanding \$235.8 million of fixed rate taxable bonds. The taxable bonds were refinanced with the issuance of the 2018 Series Bonds as described in the Note 14. Subsequent Events.

Taxable Term Note: At June 30, 2018, Advocate is party to a taxable term loan agreement (the "Term Loan Agreement" and, together with the SBPAS and CA, the "Bank Agreements") with a bank, relating to a \$115.0 million term loan from the bank, the proceeds of which were used to defease a portion of the Series 2010 Bonds. Absent an agreement between Advocate and the bank to extend the final maturity, the taxable term loan matures on August 27, 2024.

Lines of Credit: At June 30, 2018, Aurora had a \$250.0 million line of credit with a syndicate of commercial banks. The credit facility bears interest at a base rate plus a margin based on the System's current bond ratings. At June 30, 2018 a draw of \$58.5 million remained outstanding. The weighted average interest rate on the outstanding draw was 2.52% for the three months ended June 30, 2018. In August 2018, the \$58.5 million drawn on the line of credit was repaid as part of the issuance of the Series 2018 Bonds as described in Note 14. Subsequent Events.

At June 30, 2018, Aurora had a \$60.0 million line of credit, under which letters of credit can also be issued, with J.P. Morgan Chase Bank, N.A., bearing interest at the commercial bank floating rate or LIBOR plus a spread, based upon the option of Aurora. As of June 30, 2018, three letters issued under the line of credit totaling \$40.5 million was outstanding. There are currently no outstanding draws on the line of credit or letters of credit. As of August 2018, the line of credit is secured by an Obligation issued under the Advocate Aurora Master Indenture.

At June 30, 2018, Advocate had lines of credit with banks totaling \$275.0 million. No amounts were outstanding on these lines of credit as of June 30, 2018.

Under regulatory rules of the State of Illinois, Advocate is required to post a letter of credit or surety bond with a State Agency to operate a self-insured workers' compensation program. At June 30, 2018, Advocate held a surety bond in the amount of \$17.0 million. Advocate Sherman Hospital had letter of credit agreements totaling \$1.9 million at June 30, 2018, related to various construction projects. No amounts were drawn on these letters of credit as of June 30, 2018.

Other Indebtedness: The System is obligated under capital lease and financing arrangements entered into in connection with certain sale-leaseback transactions and capital leases of buildings which are reflected as long-term debt in the interim unaudited condensed consolidated balance sheet of the System. These arrangements, which relate to various administrative and medical support buildings, had initial lease terms of 15 to 25 years. At June 30, 2018, the outstanding amount of capital lease obligations and financing arrangements was \$185.5 million.

Interest Rate Swaps: Advocate entered into multiple floating-to-fixed interest rate swap arrangements with respect to the Series 2008C Bonds (collectively, the "Series 2008C Swaps") pursuant to ISDA Master Agreements. Pursuant to the Series 2008C Swaps, Wells Fargo Bank, National Association ("Wells Fargo") and PNC Bank, National Association ("PNC") pay AHCN the sum of a percentage of the one-month London Interbank Offered Rate ("LIBOR") plus a spread, and AHCN pays Wells Fargo and PNC amounts based on a fixed rate (approximately 3.605%). All Wells Fargo, PNC and AHCN payments are made on a same day net payment basis with reference to a notional amount that declines over the term of the Series 2008C Swaps. Unless terminated earlier in accordance with their terms, the Series 2008C Swaps' scheduled termination date is November 1, 2038. Under certain circumstances; however, the Series 2008C Swaps are subject to termination prior to the scheduled termination date. See Note 5. Fair Value and Note 9. Interest Rate Swap Program for discussion of the fair value and a description of the accounting treatment of Advocate's interest rate swap arrangements.

Securities Lending: As part of the management of the investment portfolio, Advocate has entered into an arrangement whereby securities owned by Advocate are loaned, primarily to brokers and investment banks. The loans are arranged through a bank. Borrowers are required to post collateral in the form of cash or highly rated securities for securities borrowed equal to approximately 102% to 105% of the value of the security loaned on a daily basis. The bank is responsible for reviewing the credit-worthiness of the borrowers. Advocate has also entered into an arrangement whereby the bank is responsible for the risk of borrower bankruptcy and default. At June 30, 2018, Advocate loaned approximately \$13.1 million, in securities and accepted collateral for these loans in the amount of \$13.5 million, which represented cash and government securities. The collateral received under the securities lending program has been reflected as a current asset and a current obligation payable in the interim unaudited condensed consolidated balance sheet presented. The balance of securities loaned and accepted collateral fluctuates daily.

### **Capital Expenditures**

For the three months ended June 30, 2018, capital expenditures of the System were \$146.5 million; at June 30, 2018 the System had \$221.1 million in construction-in-progress. The amounts in construction-in-progress relate to expansion and renovation of the Aurora Psychiatric hospital, as well as design and pre-construction costs related to the replacement hospital and new outpatient surgery center and medical office building in Sheboygan, Wisconsin, as well as the new ambulatory surgery center in Pleasant Prairie, Wisconsin. Also included within construction-in-progress is the build-out of the Advocate Medical Group Clark Street facility, expansion of the radiation oncology department at the Advocate Christ Hospital, and obstetrics renovation at the Advocate South Suburban Hospital.

The System has committed to building a hospital and medical office building on a site along the I-94 corridor in Mount Pleasant, Wisconsin. The System presently expects the hospital, medical office building and ancillary buildings to cost approximately \$250 million, with construction estimated to begin in late 2018 and be completed in 2021. Currently, management expects to fund capital commitments and expenditures with cash generated from operations and investment income, as well as from existing cash and investment balances.

### **LEGAL AND REGULATORY COMPLIANCE**

The System operates in a highly litigious industry. As a result, various lawsuits, claims and proceedings have been instituted or asserted against it from time to time. The System has knowledge of certain pending suits against certain of its entities that have arisen in the ordinary course of business. In the opinion of management, the System maintains adequate insurance and/or other financial reserves to cover the estimated potential liability for damages in these cases, or, to the extent such liability is uninsured, adverse decisions will not have a material adverse effect on the financial position or operations of the System.

As a health care provider, the System entities are subject to extensive and frequently changing federal, state and local laws and regulations governing various aspects of our business. In particular, the System entities provide a broad range of services, many of which are regulated by different government agencies, subject to differing regulatory schemes and subject to contractual reviews and program audits in the normal course of business. Many operations that the System entities undertake are subject to significant governmental certification and licensing regulations, as well as federal and state laws.

The System, like all major health care systems, periodically may be subject to investigations or audits by federal, state and local agencies involving compliance with a variety of laws and regulations. These investigations seek to determine compliance with, among other things, laws and regulations relating to Medicare and Medicaid reimbursement, including billing practices for certain services. Violation of such laws could result in substantial monetary fines, civil and/or criminal penalties and exclusion from participation in Medicare, Medicaid or similar programs.

## **Compliance and Internal Audit Programs**

The System is working to integrate the corporate compliance programs of the Legacy Systems and develop a system-wide Compliance and Integrity Program. Until the System Compliance and Integrity Program has been fully implemented, each Legacy System is operating under its current compliance program, both of which are overseen by the System Chief Compliance Officer. The System Chief Compliance Officer reports to the System Chief Integration Officer, who is a direct report to the Co-CEOs, with reporting accountability to the Audit and Compliance Committee of the System Board of Directors. Each Legacy System Program (each, "Program") is modeled after the seven essential elements of an effective compliance program, as set forth in the U.S. Health and Human Services, Office of Inspector General Compliance Program Guidance and further interpreted by the Federal Sentencing Guidelines and the U.S. Department of Justice Guidelines for the Federal Prosecution of Corporations. Each Program includes mandatory annual education of all employees regarding specific legal and regulatory requirements applicable to health care organizations, including requirements related to patient confidentiality, information privacy, information systems security, conflicts of interest, licensure and certification, federal fraud and abuse laws, billing, coding and documentation, civil rights and non-retaliation. Each Program is based on a Code of Conduct and includes an anonymous hotline available to report violations or seek guidance on compliance issues.

The System also has an internal audit department responsible for providing independent and objective assurance and consulting services designed to add value and improve the System's operations and control environment. The System Audit Officer reports functionally to the Chief Financial Officer and administratively to the Audit and Compliance Committee of the Board of Directors. The internal audit department carries out an annual audit program that assesses the System's design and operation of internal controls to achieve efficient and effective operations, accurate and reliable financial reporting, compliance with policies, laws and regulations, and the proper safeguarding of assets.

## **BOND RATINGS**

The Advocate and Aurora bonds were rated independently as of June 30, 2018. Subsequent to June 30, 2018, the System completed a refinancing of the Aurora debt portfolio which consolidated the debt under the Advocate Aurora Master Indenture. In connection with the refinancing and closing on August 16, 2018, updated ratings were obtained for all of the System's debt. Fitch assigned a rating of AA (stable outlook), Moody's assigned a rating of Aa3 (stable outlook) and S&P assigned a rating of AA (stable outlook.) Additional information on the System's bond ratings can be obtained from the Investor Relations section on <https://www.advocateaurorahealth.org/investor-relations>.

## **MANAGEMENT**

As part of the Affiliation a new executive leadership team was appointed. Key members of the management of the System are outlined within the "GOVERNANCE AND MANAGEMENT" section in Appendix A to the Official Statement dated August 16, 2018, relating to the Series 2018 Bonds. The Official statement can be accessed from the MSRB on its EMMA system, found at <http://emma.msrb.org>.

## **GOVERNANCE**

As part of the Affiliation a new board of directors for the Parent Corporation was created, the members of this board are outlined within the "GOVERNANCE AND MANAGEMENT" section in Appendix A to the Official Statement dated August 16, 2018, relating to the Series 2018 Bonds. The Official statement can be accessed from the MSRB on its EMMA system, found at <http://emma.msrb.org>.

## INDUSTRY RISKS

For a description of industry risks, see the "BONDHOLDERS' RISKS" in the Official Statement dated August 16, 2018, relating to the Series 2018 Bonds. The Official statement can be accessed from the MSRB on its EMMA system, found at <http://emma.msrb.org>.

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