

Management's Discussion and Analysis and Other Interim Information

Palmetto Health and Subsidiaries

As of and for the twelve months ended
September 30, 2017 and September 30, 2016

Palmetto Health and Subsidiaries

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Management's Discussion and Analysis

For the Twelve Months ended September 30, 2017

(dollars in thousands)

RESULTS OF OPERATIONS

Palmetto Health's earnings are reported in accordance with generally accepted accounting principles (GAAP). Management believes that earnings reported under GAAP provides a meaningful representation of its fundamental earnings power and can be used in performing period-over-period financial analysis and comparison with peer group data. This measure is also used by management in making resource allocation and other budgetary and operational decisions.

Performance Overview

Palmetto Health's revenue and gains greater (less) than expenses and losses for the year ended September 30, 2017 and 2016 is \$45,565 and \$32,348, respectively. This improvement is largely attributable to the impact of market interest rates on derivative instrument valuations and trading investments. The net change in unrealized gains (losses) on derivatives financial instruments and trading investments for the same period September 30, 2017 and 2016 is \$49,686 and \$11,975, respectively. Net nonoperating revenues (expenses) for the year ended September 30, 2017 and 2016 is \$39,651 and \$26,443, respectively. The net change is primarily attributable to investment performance due to market conditions.

Palmetto Health's operating (loss) income for the year ended September 30, 2017 and 2016 is (\$43,772) and \$17,880, respectively. The growth in total operating revenue of \$97,111 and total operating expense of \$158,763 for the year ended September 30, 2017, is partly attributable to the addition of Palmetto Health Tuomey as of January 1, 2016, contributing an incremental \$44,415 in total revenue and \$58,026 in total expenses over prior year, while Palmetto Health Tuomey's incremental impact on the operating (loss) income was a loss of \$13,611 for year ended September 30, 2017. This loss is primarily a result of decreased volumes from shifts in the Sumter and Clarendon markets, primarily occurring in the fourth quarter.

Excluding the incremental impact of Palmetto Health Tuomey being acquired January 1, 2016, total operating revenue for the year ended September 30, 2017 increased \$52,696 over the year ended September 30, 2016. These changes reflect increases in negotiated managed care rates, in addition to moderate increases in overall volume for the year.

As mentioned previously, there was a \$158,763 increase in total operating expenses for the year ended September 30, 2017. Excluding the incremental impact of Palmetto Health Tuomey, operating expenses increased \$100,737 for the year. This includes growth in both salaries and benefits expense of \$65,943, as well as growth in supplies and other expense of \$33,752. The increase in salaries and benefits related costs are driven by an increasingly competitive labor market resulting in adjustment to pay and benefit programs, a significant increase in overtime and agency utilization, accelerated hiring in areas of strategic investment and high dollar health insurance claims. In addition, in June 2017, Palmetto Health created a voluntary transition incentive program (VTIP) to offer team members the choice to voluntarily leave the organization in return for financial incentives beyond basic severance pay to support their transition. An estimate of expense under this plan of \$5,356 for 162 employees accepted under the VTIP plan were included within salaries and benefit expense on the Consolidated Statement of Operations for the year ended September 30, 2017. Spending in supplies and other reflects planned investments, service mix and technology costs. Palmetto Health management is actively engaged in returning to operating profitability, emphasizing reductions in overtime and agency utilization and changes in compensation program design.

Should you have questions on this report, please contact Paul Duane, Chief Financial Officer, at 803.296.2112.

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(dollars in thousands)

Operating (Loss) Income

	Twelve Months Ended September 30,		
	2017	2016	Change
			\$
Operating (loss) income	\$ (43,772)	\$ 17,880	\$ (61,652)

Operating (loss) income decreased \$61,652 from the year ended September 30, 2016 to September 30, 2017. This decrease is due to the increase in operating expenses of \$158,763 or 10.0%, offset by the increase in the unrestricted revenue, gains, and other support of \$97,111, or 6.1%. See further discussion of these variances on the following pages.

Unrestricted Revenue, Gains and Other Support

	Twelve Months Ended September 30,			
	2017	2016	Change	
			\$	%
Revenue at established charges	\$ 5,724,065	\$ 5,391,178	\$ 332,887	6.2%
Contractual adjustments	(3,614,281)	(3,412,313)	(201,968)	-5.9%
Charity care	(221,069)	(221,386)	317	0.1%
Disproportionate share funding	24,847	26,707	(1,860)	-7.0%
Net patient service revenue	1,913,562	1,784,186	129,376	7.3%
Provision for uncollectible accounts	(329,476)	(294,295)	(35,181)	-12.0%
Net patient service revenue less provision for uncollectible accounts	1,584,086	1,489,891	94,195	6.3%
Other revenue	118,419	118,503	(84)	-0.1%
Total	\$ 1,702,505	\$ 1,608,394	\$ 94,111	5.9%

The increase in unrestricted revenue, gains and other support was largely a result of the January 1, 2016 addition of Palmetto Health Tuomey, which contributed \$44,415 of incremental revenue in the year ended September 30, 2017. In addition, this increase in revenue reflects increases in negotiated managed care rates and moderately increased volume. There was also an increase in disproportionate share funding and provision for uncollectible accounts due primarily to addition of Palmetto Health Tuomey on January 1, 2016.

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Operating Expenses

	Twelve Months Ended September 30,			
	2017	2016	Change	
			\$	%
Salaries and benefits	\$ 970,130	\$ 867,466	\$ 102,664	11.8%
Supplies and other expenses	662,762	610,468	52,294	8.6%
Depreciation and amortization	81,193	79,337	1,856	2.3%
Interest expense	32,192	30,243	1,949	6.4%
Total expenses	<u>\$ 1,746,277</u>	<u>\$ 1,587,514</u>	<u>\$ 158,763</u>	<u>10.0%</u>

Operating expenses increased primarily due to salaries and benefits and supplies and other expenses. As discussed previously, salaries and benefits increased because of the addition of Palmetto Health Tuomey employees on January 1, 2016, an increasingly competitive labor market resulting in adjustment to pay and benefit programs, a significant increase in overtime and agency utilization, accelerated hiring in areas of strategic investment and high dollar health insurance claims.

Increases in supplies and other expenses were largely a result of the January 1, 2016 addition of Palmetto Health Tuomey. In addition, spending in supplies and other reflects planned investments, service mix and technology costs. Palmetto Health management is actively engaged in returning to operating profitability, emphasizing reductions in overtime and agency utilization and changes in compensation program design.

Palmetto Health also incurred start-up costs in relation to the new 501(c)(3) entity, the Palmetto Health University of South Carolina Medical Group (PHUSCMG) formed by Palmetto Health and the University of South Carolina School of Medicine Educational Trust (USC SOM Trust) in order offer improved care and expanded research collaboration opportunities. Integration within the new entity was launched in April 2016, with the first three practices transitioned on March 27, 2017 and a total of nine transitioned by September 30, 2017. It is anticipated that substantially all Palmetto Health and USC SOM Trust practices will be operating under PHUSCMG by the end of fiscal 2018. Employees moved to the new entity in January 2017 and were leased back to Palmetto Health during the year ended September 30, 2017. Leasing of employees ceased for the nine practices once successfully transitioned. All practices are under the new management structure. Palmetto Health and the USC SOM Trust will contribute assets for each practice as they are transitioned to the PHUSCMG. As of September 30, 2017, Palmetto Health contributed assets with a fair value of \$815. Ownership and governance is split equally between the two parties and, as such, Palmetto Health is accounting for the investment using the equity method of accounting.

Depreciation and amortization expense increased primarily due to purchases in routine capital and the January 1, 2016 addition of Palmetto Health Tuomey. The increase in interest expense is mostly from the issuance of the 2016 series bonds last fiscal year.

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Revenue and Gains Greater Than Expenses and Losses

	Twelve Months Ended September 30,		
	2017	2016	Change
			\$
Revenue and gains greater than expenses and losses	\$ 45,565	\$ 32,348	\$ 13,217

Revenues and gains over expenses and losses increased primarily from the \$54,709 increase related to the net change in unrealized (loss) gain on derivative financial instruments from a \$27,982 loss for the year ended September 30, 2016 to a \$26,727 gain for the twelve months ended September 30, 2017. There was also a \$6,952 increase in net unrealized gain on trading investments from \$16,007 for the year ended September 30, 2016 to \$22,959 for the year ended September 30, 2017. Finally, there was an \$8,283 increase in investment income from \$31,368 for the year ended September 30, 2016 to \$39,651 for the year ended September 30, 2017. These variances were due to changes in market conditions.

Increase in Unrestricted Net Assets

	Twelve Months Ended September 30,		
	2017	2016	Change
			\$
Increase in unrestricted net assets	\$ 55,908	\$ 43,075	\$ 12,833

The change in unrestricted net assets is primarily attributable to the increase in revenue and gains greater than expenses and losses of \$13,217 described above.

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LIQUIDITY, FINANCIAL RESOURCES, AND FINANCIAL POSITION

	September 30,		Change	
	2017	2016	\$	%
Total cash, cash equivalents and assets limited as to use	\$ 868,861	\$ 869,949	\$ (1,088)	-0.1%
Total assets	2,029,614	2,025,833	3,781	0.2%
Total liabilities	1,090,436	1,143,339	(52,903)	-4.6%
Total net assets	939,178	882,494	56,684	6.4%

Palmetto Health's unrestricted cash and investments fair value were approximately \$782,009 at September 30, 2017 and \$741,884 at September 30, 2016, representing 171 and 180 days of cash operating expenses, respectively. The increase in daily operating expenses adversely impacted this ratio, partially a result of the Tuomey acquisition, in addition to increased volumes and increases due to competitive labor pressures. There was an offsetting increase attributable to the \$22,810 decrease collateral held on swaps, from \$62,653 at September 30, 2016 to \$39,843 at September 30, 2017.

Palmetto Health's long-term debt balances (including current maturities) were \$780,540 at September 30, 2017 and \$797,556 at September 30, 2016, with the decrease due primarily to principal payments of \$17,770, offset by amortization. Palmetto Health's ratio of unrestricted cash and investments to long-term debt (excluding current maturities) was 100.1% at September 30, 2017, and 93.0% at September 30, 2016. This increase is as result of the principal payments described previously.

Total assets increased \$3,781 or 0.2% due to various factors. There was a \$16,646 increase in other receivables primarily attributable to the SC DSH Program changes and timing of related payments (a receivable balance of \$12,369 as of September 30, 2017 versus a payable of \$3,082 at September 30, 2016). Additionally there was a \$14,943 increase in other assets (current and noncurrent) primarily from Palmetto Health's investment of \$6,036 to acquire a 50% interest in Care Coordination Institute, LLC, a joint venture between Palmetto Health and Strategic Coordination Organization (the parent of Upstate Affiliate Organization d/b/a Greenville Health System) to support clinical integration and population health. In addition, included in the increase in other assets was an increase in net assets of Affiliated Foundations of \$4,517. There was an offsetting \$14,357 decrease in net patient accounts receivable attributed to a favorable increase in collections. Finally, there was a \$13,699 decrease in net property and equipment due to reduction in capital spending per management discretion in response to operating results.

Total liabilities decreased \$52,903 or 4.6% primarily due to the \$42,160 decrease in other current and noncurrent liabilities attributable to the \$26,727 unrealized gain (loss) derivative mark to market adjustment in twelve months ended September 30, 2017. Other liabilities also decreased \$12,197 from the decrease in the pension retirement benefit obligation due to funding by Palmetto Health, as well as favorable investment performance due to market conditions. In addition, there was a decrease in long-term debt of \$17,859 for scheduled principal payments, net of amortization. A \$6,241 offsetting increase occurred in accounts payable related to timing. Net assets increased \$56,684 or 6.4%, which relates primarily to the increase in unrestricted net assets of \$55,908 described previously.

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The status of Palmetto Health's various CON's follows:

In January 2018, DHEC approved a \$2,487 CON for the establishment of a diagnostic cardiac catheterization and interventional radiology special procedures room on the Palmetto Health Baptist Parkridge campus. This project includes equipment and renovation of existing space.

In July 2017, DHEC approved a \$1,705 CON for an MRI to be located in a physician practice office in the Columbia market. This project includes equipment and space renovation.

In July 2016, DHEC approved a \$1,950 CON for the 13 bed inpatient rehab department at the Palmetto Health Children's Hospital. This project includes equipment and space renovation. DHEC approved an extension of the implementation date through May of 2018.

Capital expenditures are \$60,000 on an average annual basis. As part of the Tuomey transaction, Palmetto Health committed \$80,000-\$100,000 for Palmetto Health Tuomey routine capital for ten years and certain upgrades in facilities and information technology.

Although no other major capital expenditures have either an approved CON or have been approved by the Board as of the date of this statement, the Board continually considers strategic capital expenditures and could approve such expenditures at any time in the future.

On November 21, 2017, Palmetto Health and the Strategic Coordinating Organization (SCO) (parent of Upstate Affiliate Organization d/b/a Greenville Health System (GHS)) finalized their agreement to create a new, not-for-profit, locally governed health company, which became the parent organization of GHS and of Palmetto Health. The new health company Board's responsibilities include developing operational and capital budgets and strategic plans for Palmetto Health and GHS.

The new health company brings together the strengths of both systems to improve the patient experience, advance clinical quality and increase access to care, while addressing rising health care costs.

A governing board of directors for the new company has been seated and is working closely with management to operationalize the new health company.

The determination of the financial impact of this transaction is currently ongoing and therefore such matters are not finally determined as of the date of issuance of this report.

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MEDICAL STAFF PROFILE

Each of Palmetto Health's hospitals has a separate medical staff. Appointments are made in conjunction with the applicable staff bylaws for each hospital. The active staffs provide all of the admissions at each of Palmetto Health's hospitals. The following tables represent a breakdown of active medical staffs at Palmetto Health's four hospitals:

PALMETTO HEALTH'S ACTIVE MEDICAL STAFF PROFILE

Specialty	PALMETTO HEALTH (EXCLUDING TUOMEY)								
	RICHLAND			BAPTIST			BAPTIST PARKRIDGE		
	Number	(% Board Certified)	Average Age	Number	(% Board Certified)	Average Age	Number	(% Board Certified)	Average Age
Anesthesiology	30	87%	56	41	88%	56	41	88%	56
Cardiology	38	97%	52	33	97%	54	19	95%	49
Dentistry	19	84%	53	13	85%	56	4	50%	55
Emergency									
Medicine	62	77%	42	64	78%	42	64	78%	42
Family Practice	50	100%	46	24	100%	47	8	100%	44
Internal Medicine	176	95%	47	139	96%	47	120	96%	45
Nephrology	23	100%	46	23	100%	46	23	100%	46
Neurology	30	97%	49	29	97%	48	26	96%	47
Neurosurgery	9	56%	47	10	60%	46	10	60%	46
OB/GYN	56	93%	51	53	92%	50	19	89%	50
Ophthalmology	25	100%	50	29	100%	49	14	100%	52
Orthopedics	40	95%	49	37	95%	50	39	95%	49
Pathology	19	95%	47	19	95%	47	19	95%	47
Pediatrics	142	97%	46	116	97%	46	45	100%	44
Psychiatry	31	94%	45	34	91%	46	13	92%	41
Radiology	30	100%	56	30	100%	56	30	100%	56
Surgery	70	96%	50	62	95%	51	47	96%	51
TOTALS/									
AVERAGE	850	92%	49	756	89%	49	541	90%	48

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MEDICAL STAFF PROFILE (continued)

<u>Specialty</u>	PALMETTO HEALTH TUOMEY		
	<u>Number</u>	<u>(% Board Certified)</u>	<u>Average Age</u>
Allergy & Immunology			
Medicine	2	100%	54
Anesthesiology	4	100%	50
Cardiovascular Disease	7	100%	52
Critical Care Telemedicine	28	100%	46
Dermatology	2	100%	50
Emergency Medicine	12	100%	47
Endocrinology	1	100%	70
Family Medicine	15	100%	49
Family Medicine			50
Gastroenterology	3	100%	51
General Surgery	5	100%	51
Thoracic Surgery	2	100%	60
Hematology/Oncology	3	100%	60
Infectious Disease	1	100%	36
Internal Medicine	19	100%	53
Nephrology	5	100%	49
Neurology (Telemedicine)	5	100%	36
Obstetrics & Gynecology	11	100%	52
Ophthalmology	2	100%	52
Oral and Maxillofacial Surgery	1	100%	64
Orthopaedic	4	100%	53
Otolaryngology	2	100%	53
Pain Management	1	100%	41
Pathology	13	100%	49
Pediatrics	8	100%	52
Plastic Surgery	1	100%	42
Podiatry	2	100%	60
Tele-Psychiatry	11	82%	48
Radiation Oncology	4	100%	54
Radiology	4	100%	53
Radiology (Telemedicine)	22	100%	51
Rheumatology	1	100%	50
Tele-Stroke	5	100%	44
Thoracic Surgery	2	100%	60
Urology	3	100%	62
Vascular Surgery	1	100%	48
TOTALS/AVERAGE	212	99%	51

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HISTORICAL UTILIZATION STATISTICS

The following table contains, for the fiscal periods indicated, selected historical utilization statistics for Palmetto Health:

	Twelve Months Ended	
	September 30,	
	2017	2016
Licensed Beds	1,392	1,439
Staffed Beds	1,291	1,315
Patient Days:		
Adult/Pediatric	303,437	286,713
Medical Rehabilitation	11,254	11,064
BMU* / Substance Abuse	23,060	24,002
Newborn/NICU	58,450	61,372
Total	396,201	383,151
Admissions:		
Adult/Pediatric	54,451	50,226
Medical Rehabilitation	967	1,102
BMU* / Substance Abuse	1,272	1,538
Newborn/NICU	17,206	17,337
Total	73,896	70,203
Length of Stay (Adult/Pediatric)	5.57	5.71
Occupancy Percentage:		
Licensed Beds	78.0%	81.3%
Staffed Beds	84.1%	86.7%
ER Visits	239,406	220,179

*Behavioral Medicine Unit.

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HISTORICAL COVERAGE OF MAXIMUM ANNUAL DEBT SERVICE

The following table shows, for the fiscal periods indicated, Palmetto Health's income available for debt service, calculated in accordance with the Master Indenture, and the extent to which principal and interest requirements on all long-term debt and capitalized leases outstanding at that time were covered by such revenues.

	Twelve Months Ended	
	September 30,	
	2017	2016
Revenues and gains over expense	\$ 45,565	\$ 32,348
Plus: Depreciation and Amortization	81,193	79,337
Interest	32,192	30,243
Net change in unrealized (gain) loss on derivative financial instruments	(26,727)	27,982
Net change in unrealized gain on trading investments	(22,959)	(16,007)
Income available for debt service	\$ 109,264	\$ 153,903
Maximum Debt Service Requirement on all long-term debt	\$ 63,458	\$ 62,018
Debt service coverage (times)	1.7	2.5

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CAPITALIZATION

The table below sets forth, for the fiscal periods indicated, the capitalization of Palmetto Health:

	September 30,	
	2017	2016
Series 2016 Bonds	\$ 120,000	\$ 120,000
Series 2014 Bonds	18,085	18,085
Series 2013 Bonds	109,380	113,130
Series 2011 Bonds	81,135	82,055
Series 2010 Bonds	198,418	203,183
Series 2009 Bonds	85,925	89,010
Series 2005 Bonds	179,625	184,775
Other Long-Term Indebtedness	18,256	19,228
Total Long-Term Debt	810,824	829,466
Less: Current Maturities	(18,722)	(17,888)
Unamortized Bond Discount	(12,028)	(12,782)
Net Long-Term Debt	780,074	798,796
Total Unrestricted Net Assets	892,276	836,368
Total Capitalization	\$ 1,672,350	\$ 1,635,164
Net Long-Term Debt as a Percentage of Total Capitalization	47%	49%